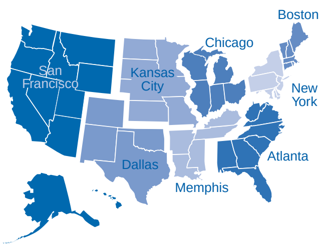
Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION | FOURTH QUARTER 2001

FDIC NATIONAL EDITION



DIVISION OF INSURANCE

In Focus This Quarter

◆ ***Economic Conditions and Emerging Risks in Banking***—After slowing significantly during the first eight months of 2001, the U.S. economy suffered an additional shock from the September 11 terrorist attacks on New York and Washington. As a result, most economists now expect the contraction in the economy that began in the third quarter to last at least through the end of the year. The depth and duration of this downturn will be determined by a confluence of factors, including the effects of monetary and fiscal stimulus and the degree of financial vulnerability in the consumer and business sectors.

Overall, the U.S. banking industry appears well positioned to withstand a period of economic adversity and continue to provide credit to finance the economic recovery. This article discusses a combination of factors that may affect some banks—particularly those that rely on rapid loan or new account growth or that exhibit heightened credit risk profiles—in this more challenging economic environment. The article also identifies weaknesses that may exist in some previously booming metro areas as the local economies continue to slow. *See page 3.*

By the Division of Insurance Staff

Regional Perspectives

◆ ***Atlanta***—Declining growth in some areas with concentrations in the manufacturing and high-tech sectors has contributed to deterioration in credit quality and could adversely affect banking industry profitability. *See page 14.*

◆ ***Boston***—The Region's insured institutions report healthy conditions. However, net interest margin compression and the potential for rising interest rate risk during a slowing economy could pressure earnings. *See page 17.*

◆ ***Chicago***—Modest declines in credit quality have become more widespread among insured institutions. Continued slowing of economic conditions and ramifications from the September 11, 2001, attacks could lead to further weakening. *See page 20.*

◆ ***Dallas***—Continued stress in the high-tech industry has contributed to softening in certain commercial real estate markets and to overall weakening in the Region's economy this year. *See page 24.*

◆ ***Kansas City***—Farm banks in counties with relatively high reliance on government agriculture payments have exhibited higher levels of credit risk and are more vulnerable to any changes in these support programs. *See page 27.*

◆ ***Memphis***—Credit quality, already showing some deterioration because of the Region's prolonged weak economic conditions, could decline further should the national economy continue to slow. *See page 30.*

◆ ***New York***—Heightened economic uncertainty following September 11 has placed additional pressure on bank earnings and credit quality. However, the Region's insured institutions appear better positioned for an economic downturn than in the early 1990s. *See page 34.*

◆ ***San Francisco***—Softening in some commercial real estate markets, deteriorating housing affordability, and increasing stress in the agricultural sector could adversely affect the quality of some real estate and farm loan portfolios. *See page 38.*

The ***Regional Outlook*** is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

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Risk in the Banking Sector during a Time of Uncertainty

Introduction

After slowing significantly during the first eight months of 2001, the U.S. economy suffered an additional shock from the September 11 terrorist attacks on New York and Washington. While the immediate effects were most severe for industries such as airlines, insurance, lodging, and gaming, the broader effects have included a more widespread erosion of consumer and business confidence. As a result, the U.S. economy contracted slightly in the third quarter of the year, and most economists now agree that the economy will experience at least two consecutive quarters of negative growth. The depth and duration of this downturn, however, will be determined by a confluence of factors, including the effects of monetary and fiscal stimulus and the degree of financial vulnerability in the consumer and business sectors.

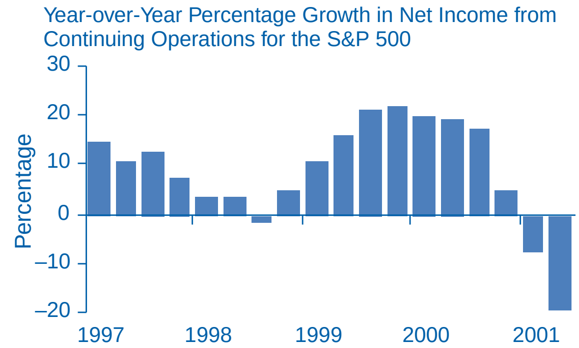
Overall, the U.S. banking industry appears well positioned to withstand a period of economic adversity and continue to provide credit to finance the economic recovery. That said, however, current trends suggest that insured institutions will face challenges across the balance sheet. The effects of the slowdown could be most pronounced for institutions with growth-oriented business models or high credit risk profiles. In addition, institutions in previously booming metro areas with concentrations in traditionally higher-risk loan categories may need to consider carefully the implications of a significant slowdown in their local economies.

The U.S. Economy Was Slowing Sharply before September 11

The U.S. economy appeared to be headed for a recession before the terrorist attacks. Following a 1.3 percent increase in first quarter 2001, growth in gross domestic product (GDP) virtually stalled in the second quarter, with an annualized quarterly growth rate of a mere 0.3 percent. The slowdown in the economy throughout the first half of 2001 was driven primarily by weaknesses in the corporate sector. Following two consecutive years of double-digit growth, corporate profits plummeted. Corporate operating profits for the S&P 500 companies fell 19 percent in the second quarter of 2001 from a year ago (see Chart 1). Reflecting the sharp decline in corporate profits and falling share prices, business investment also trended downward throughout the year. During second quarter 2001, business investment fell by 2 percent from a year earlier, the first year-over-year decline since early 1992. Investment in equipment and software fell by an annualized 15.4 percent during the same quarter, the third consecutive quarterly decline. This measure of business investment has not declined for three consecutive quarters since the recession of 1981–1982.

CHART 1

Corporate Profits Dropped Markedly in the First Half of 2001



Source: Bloomberg

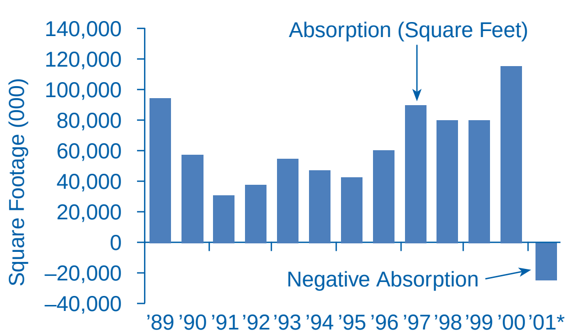
The slowing economy and difficulties in the corporate sector led to an unprecedented decline in demand for office space during the first half of 2001. Overall, net absorption in 53 markets tracked by ***Torto Wheaton Research*** was negative for the first time in the 20-year history of this series (see Chart 2, next page).[1] During the first six months of this year the U.S. office vacancy rate rose by 250 basis points, to 10.8 percent. At the same time, weaknesses in the manufacturing sector contributed to negative absorption of industrial properties. As demand for space for storage and distribution fell, the vacancy rate for industrial properties jumped 140 basis points, to 8.1 percent nationwide.[2]

[1] Negative net absorption means that the amount of vacated space exceeds the amount of newly occupied office space. For additional information, see "Slowing Economy Reduces Demand for U.S. Office Space," *Regional Outlook*, third quarter 2001.

[2] Data from Torto Wheaton Research.

Chart 2

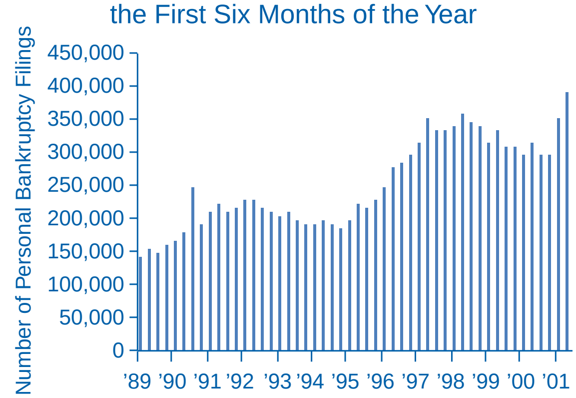
Office Markets Experienced Unprecedented Negative Absorption in Early 2001



* 2001 as of June 30
Source: Torto Wheaton Research

Chart 3

Personal Bankruptcy Filings Rose Sharply during the First Six Months of the Year



Source: Administrative Office of the U.S. Courts

The consumer sector continued to prop up the U.S. economy through the early months of the year, although some signs of vulnerability in the sector began to emerge. Low interest rates and the relatively healthy employment market helped to maintain modest growth in consumer spending throughout the first half of the year. Home sales remained near historically high levels as mortgage rates fell. Lower mortgage rates also boosted mortgage refinancing activities, which provided additional liquidity to fund consumer spending. According to ***Freddie Mac,*** nearly 60 percent of mortgage loans refinanced in second quarter 2001 were for cash-out refinancing, where the refinanced amount exceeded the original loan amount by 5 percent or more. Automobile sales also remained strong in the first half of the year.

However, problems in the corporate sector have begun to spread to the consumer sector as the steady stream of corporate layoffs pushed the unemployment rate up sharply this year. Although low by historical standards, the steady upward trend in the unemployment rate throughout the year is consistent with a recession. Meanwhile, unprecedented growth in consumer indebtedness began to weigh on consumers, and the total household debt-service burden[3] exceeded 14 percent in second quarter 2001, the highest level since 1987.[4] Personal bankruptcy filings have spiked for two consecutive quarters (see Chart 3), and mortgage loan delinquencies, particularly among high loan-to-value mortgages, rose sharply in the first half of the year.

The September 11 Attacks Have Increased Uncertainty about the U.S. Economy

The events of September 11 had immediate adverse effects on certain industries. Air transportation, insurance, lodging, and gaming, which were experiencing difficulties before September 11 as the economy slowed, were particularly hard hit. Forecasts for the airlines issued after September 11 call for losses amounting to \$6.5 billion in 2001 and \$3.5 billion in 2002.[5] Insured loss estimates associated with September 11 range from \$30 billion to \$70 billion, making it the largest insurance loss event in U.S. history.[6] With curtailment in tourism and business travel, hotel occupancy rates have fallen sharply. Nationwide, the occupancy rate was estimated at 30 percent in late September, well below breakeven.[7] Revenues per available room (RevPAR) for 2001 are forecast to be significantly lower than a year ago, with some estimating a 9 percent to 13 percent annual decline in RevPAR for the year.[8]

In addition, the attacks adversely affected consumer and business confidence. According to the ***Conference Board,*** the consumer confidence index dropped to 85.5 in October, the lowest level since early 1994. This followed a 16.4-point drop in September, the largest one-month drop since Iraq invaded Kuwait in August 1990 (see Chart 4). The U.S. economy contracted slightly in third quarter 2001 for the first time in more than eight

[3] The household debt-service burden is an estimate of the ratio of mortgage and consumer debt payments to disposable personal income.

[4] Data provided to Haver Analytics by the Federal Reserve Board.

[5] Merrill Lynch. October 2001. *Airline Industry*.

[6] Deutsche Banc. Alex Brown. October 2, 2001. *P & C Insurance Monthly*.

[7] Givens, David. September 26, 2001. "Unoccupied." *The Dismal Scientist*.

[8] Goldman Sachs. September 27, 2001. *Lodging*.

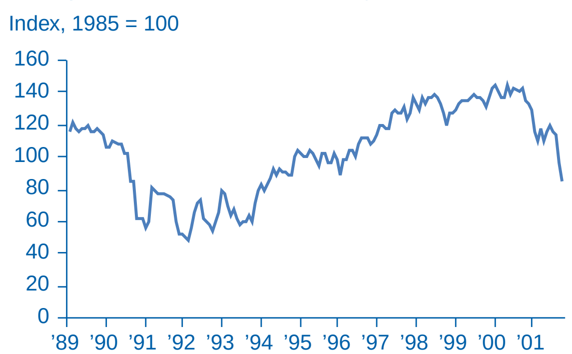
years.[9] According to the ***Blue Chip Economic Indicators*** surveyed since September 11, the consensus forecast calls for two consecutive quarters of negative growth in the third and fourth quarters of 2001.[10] The consensus forecast for growth in first quarter 2002 is also less than one sixth of the estimate before September 11.

Given the high level of uncertainty in terms of national security and the economy, the turning point for the U.S. economy is difficult to determine. By all indications, the current economic environment is very different from the two previous recessions, in the early 1980s and 1990s. While the high inflationary pressure that accompanied recent recessions is absent this time, there are a number of new vulnerabilities in the economy. The depth and duration of this downturn will be influenced by a confluence of factors, including the effects of monetary and fiscal policies designed to stimulate the economy and vulnerabilities in the consumer and business sectors that developed during the 1990s expansion.

Throughout the year, monetary and fiscal authorities have responded aggressively to signs of weaknesses in the economy. The Federal Reserve has lowered the benchmark Federal Funds rate by 150 additional basis points since September 11, with a cumulative rate cut for the year of 450 basis points. At the same time, growth in the money supply has been robust throughout 2001 and has accelerated as the U.S. economy slowed.

CHART 4

Consumer Confidence Dropped Sharply after September 11 amid Growing Uncertainties



Source: Conference Board (Haver Analytics)

[9] According to the National Bureau of Economic Research (NBER), the U.S. economy entered a recession in March 2001.

[10] November 10, 2001. *Blue Chip Economic Indicators*.

Low inflation has given the Federal Reserve more flexibility to ease its policy stance in response to a slowing economy. As the federal government responds to the aftershock of the terrorist attacks, some analysts estimate that the combination of tax cuts and increased federal spending could represent about 1 1/2 percent of GDP this year.[11] These fiscal stimuli could contribute to an economic recovery over the longer term.

Vulnerabilities in the Economy May Offset Some of the Positive Effects of Recent Policy Changes

Many economists expect a relatively short and mild recession because of the magnitude of monetary and fiscal stimulus.[12] However, several underlying vulnerabilities in the economy could deepen or prolong the current downturn. The extent of these vulnerabilities, ranging from the unwinding of asset price bubbles[13] to a high level of consumer and business leverage, is likely to determine the effectiveness of recent policy actions.

Synchronized Global Economic Downturn

The global economy is in the midst of the first synchronized economic downturn since the oil crises of the 1970s. As the three largest economies—the United States, Japan, and Germany—are at or near recession, the global economy currently lacks an anchor to sustain growth (see Chart 5, next page). In addition to weak domestic demand, the U.S. economy is likely to face a sharp decline in exports, making an export-driven recovery difficult to achieve.

Unwinding of Asset Price Bubbles

On the corporate side, the rapid asset price appreciation that preceded the current downturn contributed to a significant amount of overinvestment in certain industry sectors, such as telecommunications and computer

[11] October 8, 2001. Morgan Stanley. *Global Economic Forum*.

[12] The consensus forecast of 51 economists surveyed by Blue Chip Economic Indicators calls for negative 1.3 percent growth in real GDP for the fourth quarter of 2001. The consensus forecast shows 0.5 percent growth for first quarter 2002.

[13] In the context of this article, the term "asset bubble" refers to rapid appreciation in equity prices relative to growth in corporate earnings. One measurement of equity fundamentals, the price-to-earnings ratio for the S&P 500, peaked at 43.5 in April 2000, nearly three times higher than the long-term average between 1901 and 1999. For more discussion of asset price bubbles, see Robert J. Shiller. 2000. *Irrational Exuberance*, Princeton University Press.

CHART 5

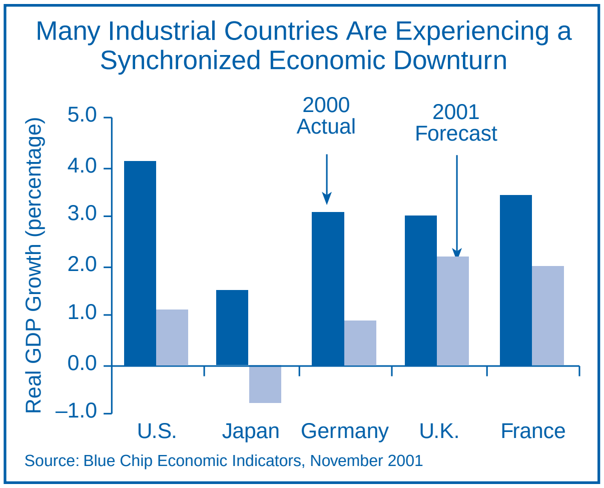
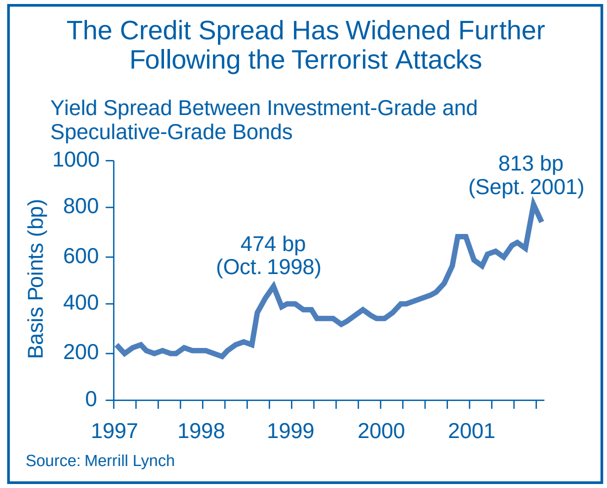


CHART 6



equipment. Resulting supply imbalances may take longer to correct than previously anticipated as demand continues to falter. Analysts now expect the decline in corporate profits in the high-tech sector to continue into early 2002. The communications service sector, which began to experience difficulties in third quarter 2000, is expected to report lower earnings through the end of this year.[14]

Capital Market Weaknesses

Increased risk aversion in financial markets following recent events may further constrain the amount of credit available through capital markets. Lifted by the buoyant equity market, many businesses increasingly relied on capital markets throughout the 1990s. Poor equity market performance all but dried up initial public offerings (IPOs) in third quarter 2001, and the outlook for IPOs in the near future remains negative.[15] At the same time, the yield spread between investment-grade and high-yield bonds widened sharply in late September (see Chart 6).[16] Although the spread narrowed somewhat in October, it remains very high from a historical perspective. The spread is likely to remain wide as uncertainty about the economy tempers investors' appetite for risk, creating a challenging borrowing environment for non-investment-grade companies.

High Degree of Leverage

A high degree of leverage among consumers and businesses alike raises concerns about their vulnerability to a slowing economy. The ratio of corporate debt to cash flow reached an historic high of 655 percent in second quarter 2001.[17] As cash flow weakens during a slowing economy, highly leveraged businesses may experience greater difficulty in servicing debts. A high level of consumer indebtedness also leaves the consumer sector vulnerable in an economic environment that is characterized by rising unemployment, weaker real personal income appreciation, and lower asset values.

Slowdown in Home Price Appreciation

Mortgage origination and refinancing, bolstered by appreciation in home prices, has injected additional liquidity into the economy over the past few years. However, the sustainability of recent rates of home price appreciation is in question as the economy enters a cyclical downturn. Although median existing home prices continued to appreciate in third quarter 2001, median new home prices fell by 4.2 percent during the quarter, the sharpest quarterly decline since third quarter 1990. Growth in home prices slowed during the past two recessions as inflation-adjusted personal income fell.[18] Continued appreciation in housing prices is particularly important to homeowners who relied on high loan-to-value loans to purchase their residences and those who obtained liquidity through cash-out refinancing using a home equity buildup. If

[14] First Call.

[15] According to IPO.com, only 11 IPOs came to market in July and August, and there were no offerings in September. In comparison, 134 IPOs were brought to market in third quarter 2000. For historical data on IPOs, see http://bear.cba.ufl.edu/ritter/ipoall.htm.

[16] The spread of the effective yield between Merrill Lynch investment-grade and speculative-grade bond indices reached 809 basis points on October 2, 2001, the highest level in nearly ten years.

[17] Corporate debt-service burden is total nonfarm, nonfinancial corporate credit market debt as a percentage of total cash flow. Data provided to Haver Analytics by the Federal Reserve Board.

[18] The housing price index compiled by the Office of Federal Housing Enterprise Oversight shows a sharp slowdown in housing price appreciation in 1982 and late 1990 through 1991.

home price appreciation drops significantly and the employment situation continues to worsen, homeowners' capacity and willingness to repay mortgage loans could decline, resulting in higher mortgage loan losses.

A Confluence of Factors May Squeeze Bank Earnings

The current economic environment will pose challenges for the banking industry, with possible effects across the balance sheet. Insured institutions can expect higher loan losses as the economic downturn begins to affect their borrowers. Some institutions also may experience lower earnings from their capital market activities. Although low short-term interest rates may benefit insured institutions in the longer term, some community banks may continue to experience a squeeze in the net interest margin (NIM) in the near term, as their variable-rate loans reprice downward more quickly than their deposits.

Credit Quality

Depending on the length and depth of the economic slowdown, credit weakness, which to date has been limited mainly to large syndicated loans, may spread to some degree to medium and smaller credits, commercial real estate, and consumer credit. Results of the 2001 ***Shared National Credit*** (SNC)[19] review, completed before September 11, showed a marked deterioration in the performance of loans to larger companies. During this review, adversely rated loans rose 93 percent from year-earlier levels to $193 billion, or 9.4 percent of total SNC commitments. The quality of loans to smaller companies deteriorated somewhat in the third quarter, with some regional banks reporting more than a 20 percent increase in nonperforming loans among medium and smaller credits between second and third quarter 2001.[20]

Prospects for near-term improvement in corporate credit quality are not good. According to ***Moody's,*** corporate bond rating downgrades outnumbered upgrades more than four to one in third quarter 2001.[21] These revisions correspond to a significant rise in the rate of speculative bond defaults, which rose to 9 percent during the 12 months ended September 30, 2001, from 5.7 percent for the 12 months ended December 31, 2000. Following the terrorist attacks, Moody's revised its forecast of peak speculative bond default rates from 10 percent to 11 percent during the first half of 2002 (see Chart 7).

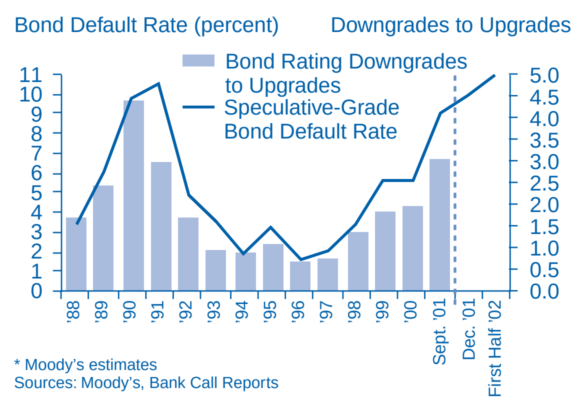
Consumer loan performance also has weakened somewhat during 2001. Significant and continuing layoffs following the September 11 attacks have begun to push the unemployment rate upward. Following two consecutive monthly declines, nonfarm employment dropped by an additional 415,000 in October. The unemployment rate in October jumped to 5.4 percent from 4.9 percent a month earlier. Increasing unemployment, combined with historically high household debt burdens, could place upward pressure on consumer loan loss rates in the coming months.

Market-Sensitive Revenues

Insured institutions also may experience earnings pressure from nontraditional activities. Financial market weakness may continue to depress market-related activities and put significant downward pressure on market-sensitive revenues that have supplemented traditional sources of income, particularly among large banking companies. Revenues derived from investment banking; advisory, brokerage, and trading activities; and venture capital tend to be sensitive to changes in financial market conditions, including valuation, trading volume, and new security issuance.

CHART 7

The Default Rate on Speculative Bonds Rose Sharply during the First Nine Months of the Year



* Moody's estimates
Sources: Moody's, Bank Call Reports

[19] The annual interagency review encompasses roughly $2.1 trillion in commercial loan syndications, covering credit commitments totaling $20 million or more that are shared between two or more supervised lending institutions.

[20] Chaffin, Joshua, and Silverman, Gary. October 17, 2001. "Credit Problems Spreading, Say Banks." *Financial Times*.

[21] October 11, 2001. "Rating Reviews Suggest Bumpy Road Ahead for U.S. Corporate Credit Worth." *Moody's Credit Trends.*

The S&P and NASDAQ fell by 9 percent and 14 percent, respectively, between August and October 2001. Equity underwriting volume dropped by more than 50 percent in the third quarter from a quarter earlier, while debt underwriting volume declined by about 41 percent during the same period.[22] Merger and acquisition volume in the third quarter is estimated to be off by 45 percent from a year ago.[23] These capital market weaknesses are expected to continue in the near term, which may squeeze earnings among banking companies that derive significant income from capital market activities.

Margin Pressures

Although the effects of falling short-term rates and a steeper yield curve may benefit bank earnings in the long run, many community banks may experience a squeeze in NIM in the near term. In particular, banks with relatively interest-rate-sensitive asset portfolios may suffer margin compression, as loans tied to prime or LIBOR (London Interbank Offered Rate) reprice downward quickly. Rates on deposits, which are near what some observers see as a functional floor, may have less room to reprice downward. Additionally, a sharp increase in mortgage refinancing activity as mortgage rates fall may result in the origination of long-term, low-rate assets, further squeezing NIMs.

The Banking Industry Is Well Prepared Going into a Cyclical Downturn

Overall, the banking industry is more diversified geographically and much stronger financially going into a recession now than it was before the last recession. Following the implementation of the Interstate Banking Efficiency Act in 1997, many national banks were able to diversify their loan portfolios geographically, and they became less dependent on regional economic conditions than they were in the early 1990s. Geographic diversification should help banks better withstand the regional economic shock that may result from a current downturn.

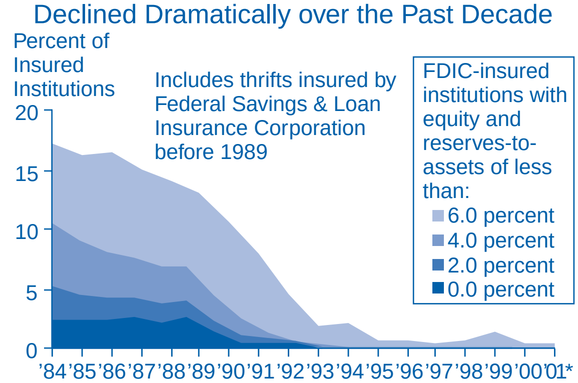
Also, the banking industry is much better capitalized than it was in the early 1990s. In June 2001, fewer than 1 percent of commercial banks and thrifts reported a ratio of equity and reserves to total assets of less than 6 percent (see Chart 8). In comparison, in June 1990 about 11.5 percent of all insured institutions reported equity and reserves of less than 6 percent of total assets.[24] High capital levels will give the industry a fairly large cushion to absorb the higher credit costs, lower margins, and declining fee-based revenues that may result from this cyclical downturn. In addition, the maturing of the secondary market for loans in the 1990s has enabled banks to reduce problem credits through loan sales. Credit quality among insured institutions is significantly better now than it was going into the last recession.

Industry capital levels have been augmented by strong earnings performance over the past few years, driven by loan growth and noninterest revenues from a variety of sources, ranging from capital market activities to fee income from loan servicing activities. Noninterest income represented 2.2 percent of average assets for the industry in June 2001, compared with 1.3 percent in June 1990. The return on average assets for the industry was nearly five times higher in June 2001 than it was going into the 1990–1991 recession. The number of unprofitable institutions also has declined significantly since 1990. Fewer than 8 percent of commercial banks and thrifts were unprofitable as of June 2001. In comparison, nearly 15 percent of institutions were unprofitable in June 1990.

The impact of the economic downturn on insured institutions will not be uniform but will depend on the risk exposure and market niches of particular institutions. The remainder of this article attempts to identify the

Chart 8

The Number of Thinly Capitalized Institutions Has Declined Dramatically over the Past Decade



* As of June 2001
Source: Bank and Thrift Call Reports

[22] U.S. Bancorp Piper Jaffray. October 2001. *Banks & Investment Banks: Capital Markets Quarterly*.

[23] Data from Thomson Financial.

[24] According to the National Bureau of Economic Research, third quarter 1990 marked the beginning of the 1990–1991 recession.

banking lines of business and geographic areas that may be at higher risk in this economic slowdown.

Some Insured Institutions May Be Vulnerable in This Environment

The effects of an economic downturn may be more pronounced for certain banking business models. Insured institutions whose earnings may be at greater risk include those that rely heavily on new accounts or rapid loan growth to sustain earnings. Slower loan growth coupled with higher loan losses could challenge these institutions. Institutions with a high degree of operating leverage also could be negatively affected. Because of relatively fixed cost structures coupled with variable revenue streams, these institutions could see a decline in profits as the economy continues to slow.

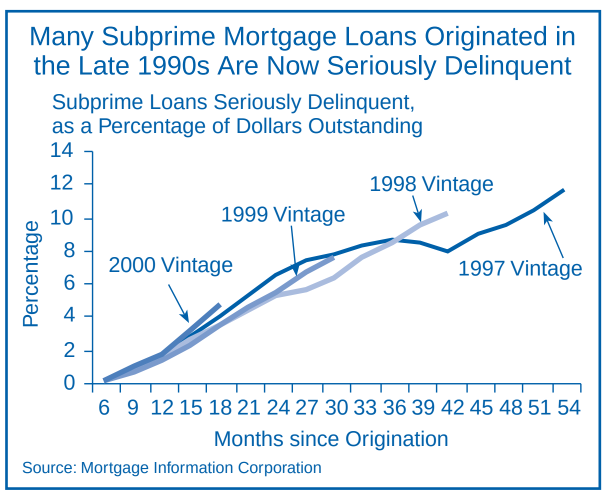
Insured institutions that engaged in aggressive loan underwriting and risk selection practices during the latest economic expansion may face increased challenges in a downturn. The rapid expansion of leveraged financing in the latter half of the 1990s is producing higher levels of problem commercial loans at some institutions. Some of the more aggressive loans underwritten during this period, which rely on "enterprise value" as a secondary source of repayment to "augment or otherwise mitigate deficient equity and values,"[25] may be especially vulnerable to slowing economic conditions. Because enterprise value is often contingent upon sustained growth in borrower income and cash flows, reliance on enterprise value could increase the risk in leveraged financing.[26] Similarly, some construction and commercial real estate loans made at the height of the boom in various local real estate markets may be vulnerable to the extent that property cash flows (and income-derived property valuations) fall in response to lower rents.

Other types of lending activities that are vulnerable to a slowing economy include those focused on borrowers with lower credit quality or higher leverage, who tend to be most vulnerable to adverse economic trends. According to the ***FDIC's Division of Supervision***, subprime lenders, which constitute less than 2 percent of all insured institutions, currently represent 13 percent of institutions with supervisory concerns. Subprime loan portfolios, which include loans extended to borrowers with weak credit histories or questionable repayment capacity, are likely to come under increasing stress as the economy slows. According to the vintage analysis of ***Mortgage Information Corporation***, more than 10 percent of subprime mortgage loan pools originated in 1997 and 1998 were seriously delinquent in June 2001.[27] Subprime mortgage loan pools originated in 2000 thus far have performed worse than earlier loan pools, exhibiting a higher rate of delinquency and foreclosure over the first 18 months of seasoning (see Chart 9). Delinquency rates on Federal Housing Administration and Veterans Administration loans also have begun to rise recently, which could mean increasing stress for mortgage lenders that specialize in high loan-to-value loans.

The Nation's Midsection Has, Thus Far, Borne the Brunt of the Slowdown

Just as the effects of the current economic slowdown have been more pronounced on particular banking lines of business, certain geographic areas have been affected more adversely. Economic weakness through midyear 2001 has been concentrated primarily in Midwest and Midsouth states (see Map 1, next page). Six of those states (**Alabama, Indiana, Michigan, Mississippi, Missouri,** and **Nebraska**) reported a significant

CHART 9



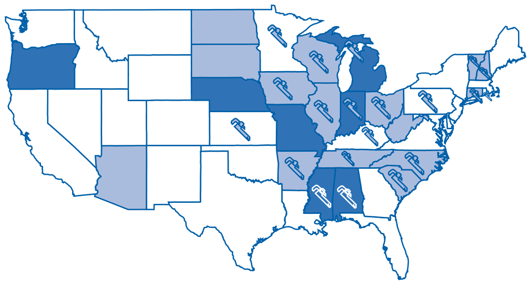
[25] See Office of the Comptroller of the Currency (OCC), Advisory Letter AL 99-4, May 1999.

[26] Primary and secondary repayment sources for enterprise value loans—equity or collateral value and cash flows—are closely linked. As a result, enterprise value can fail to provide a source of repayment in the stress environment where equity or collateral value is at risk. See OCC Advisory Letter AL 99-4 and Interagency Guideline on Leveraged Financing, April 2001.

[27] Loans are considered seriously delinquent if they are delinquent for 90 days or more.

Map 1

The Recession in the Manufacturing Sector Has Been a Factor in These States' Weak Performance*



Nonfarm Payroll Growth, June 2001/June 2000

- Less than 25 percent of 1992–2000 average
- Decline of 0.2 percent or more
- States in which the share of jobs in manufacturing is at least 110 percent of the U.S. share

*Employment growth is shown as a proxy for overall economic conditions.
Source: Bureau of Labor Statistics

decrease in employment between June 2000 and June 2001.

The economic slowdown in this part of the country is related to the high concentration of manufacturing employment. The manufacturing sector has been in contraction since August 2000, according to the ***National Association of Purchasing Managers Index.*** In some states, the manufacturing sector has been affected more adversely because of the specific mix of industries. For example, appliance production has fared worse than automobile production.

The downturn in the manufacturing sector is not the only factor stressing the economic performance of these states, however. Many are also dependent on the agricultural sector. Most agricultural commodity prices have been relatively low since 1997, and certain areas, notably the South, experienced poor growing conditions in one or more years before 2001. Lingering weaknesses in this sector have had an adverse effect on many rural communities, as evidenced by lower levels of retail sales and declining demand for services. Despite these weaknesses, little deterioration has been reported in insured institution agricultural credit quality, in large part because of substantial government subsidies to agriculture and strong gains in off-farm income. Continued support from these sources is uncertain, as the 1996 Farm Bill expires next year, and new legislation could change the level and nature of government farm subsidies. In addition, off-farm income levels may suffer because of the considerable job losses now occurring in the manufacturing sector in many rural areas.[28]

While farm bank credit quality is not showing signs of weakness currently, the prolonged economic slowing in the nation's midsection has affected reported bank and thrift credit quality generally. Insured financial institutions in the Midwest and Midsouth are reporting rising credit delinquencies, as shown on Map 2. Increases in past-due and nonaccrual loan levels are being driven in large part by rising delinquencies in the household and commercial real estate segments of loan portfolios.[29] Mounting job losses combined with high consumer debt levels are stressing the financial capacity of many households, as evidenced by the increasing number of bankruptcy petitions being filed. A slowing economy also is affecting the supply and demand balance for real estate adversely, as highlighted by the net negative absorption of office space during the first half of 2001.

As previously discussed, trends before September 11 suggest that the economic slowdown was spreading to other economic sectors and geographic areas. As the national economy continues to slow, states in the nation's midsection, many of which were stressed by a prolonged localized downturn, may continue to suffer disproportionately in the near term. Similarly, credit quality of banks and thrifts operating in these areas likely will continue to be pressured.

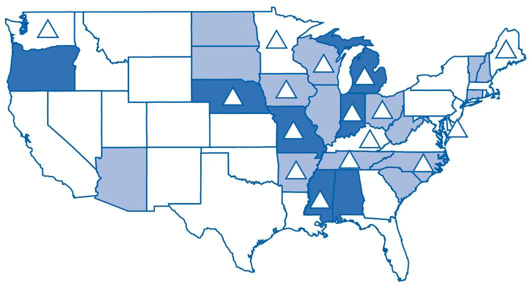
Should the economic downturn deepen and the effects spread to other areas of the country, insured institutions operating in certain metropolitan markets that previously enjoyed rapid economic growth could experience more serious problems. These institutions may find the challenge of transitioning from an environment of dynamic growth particularly difficult.

[28] For additional information on the importance of government payments and the 2002 Farm Bill debate, see Kansas City, *Regional Perspectives,* fourth quarter 2001.

[29] For additional information on credit quality deterioration in the nation's midsection, see Chicago and Memphis, *Regional Perspectives,* fourth quarter 2001.

Map 2

The Majority of Banks Reporting a Significant Increase in Past-Due Loan Levels Are in the Midwest



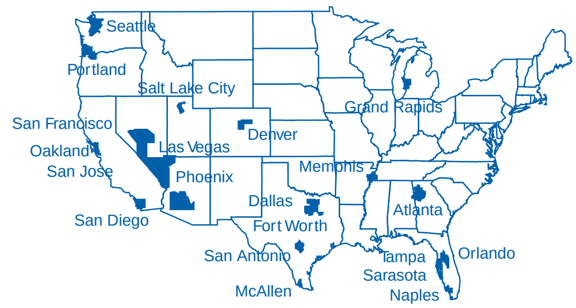
Nonfarm Payroll Growth, June 2001/June 2000

- Less than 25 percent of 1992–2000 average
- Decline of 0.2 percent or more
- △ States in which at least 50 percent of institutions reported a 25 basis point increase in past-due loans (June 2001/June 2000)

*Employment growth is shown as a proxy for overall economic conditions.
Source: Research Information System

Map 3

Banking Markets That Have Experienced Rapid Economic Growth, Strong Loan Growth, and High Credit Exposure May Be More Vulnerable during an Economic Downturn



Some Banking Markets May Be Particularly Vulnerable during an Economic Downturn

The historic ten-year expansion contributed to significant growth and prosperity, driven by strong gains in the service sector and buoyant real estate markets in many of the nation's metropolitan areas. However, the areas that experienced the greatest economic growth may be more vulnerable during a slowing economy. Many insured financial institutions operating in these markets exhibit characteristics that suggest elevated risk profiles, including rapid loan growth, high credit exposure, intense competitive pressures, and a growing reliance on noncore funding sources.

Map 3 shows 21 metropolitan markets,[30] located predominantly in the South and West, that fit this profile. The primary factors that suggest that these banking markets may be more vulnerable during a downturn are explained below. These characteristics were shown to be contributing factors to higher failure rates of insured institutions during the 1980s and early 1990s (see box on page 13 for more details).

- **Above-average economic growth.** This growth could prove unsustainable. For all 21 markets shown, the average annual growth in gross metropolitan product for 1992 to 2000 exceeded the average annual growth rate of 4.43 percent for all metropolitan areas nationally. Annual growth was 5.3 percent or more in 17 of the 21 markets.

- **Rapid loan growth.** The median loan growth rate of banks and thrifts in each market was among the top quintile of all metropolitan markets considered in the analysis for either a five-year or one-year period. The use of these two time periods captures markets experiencing a sustained period of loan growth and those that were among the fastest-growing markets even as the nation's economy has cooled.

- **High credit exposure.** Two measures of credit concentrations relative to leverage capital were considered in determining whether a market exhibited high credit exposure: construction and development (C&D) lending and a more broadly defined "higher-risk" lending type. C&D lending was considered in isolation because of the close link between this loan type and local real estate market conditions.[31] The broader category of higher-risk loans includes all commercial and commercial real estate loans. This measure of credit exposure was included because such loan concentrations traditionally have been associated with a higher rate of failure among insured financial institutions.[32] A market was considered to

[30] This analysis was limited to banking markets with ten or more insured financial institutions headquartered in the metropolitan area. Only insured financial institutions considered to be tied to local economic conditions were included in the analysis; as a result, the sample excluded any institutions with more than $10 billion in total assets, credit card lenders, and special-purpose institutions.

[31] This measure of potential credit risk and its relationship to real estate market conditions was discussed in more detail in "Emerging Risks in an Aging Economic Expansion," *Regional Outlook,* fourth quarter 2000.
[32] For additional information on high-risk loans, see "Economic Risks and Emerging Risks in Banking," *Regional Outlook,* second quarter 2001.

have high credit exposure if the median concentration ratio for either measure of credit exposure among banks and thrifts in the market ranked among the top quintile of all markets considered in the analysis.

The 21 markets share other characteristics. In all of these markets, rapid loan growth was supported largely by higher-cost and potentially more volatile noncore funding sources.[33] While banks and thrifts nationally have relied increasingly on these alternative funding sources, insured institutions in these metropolitan markets typically reported a greater reliance on noncore funding than institutions in most other areas of the country. Intense competition for local deposits has contributed to increased use of noncore funding. Competitive pressures also likely have affected loan pricing as well as underwriting standards at some insured institutions in these markets. In addition, new bank formation is a key factor driving competition, a trend that was most evident in the Southeast and West during the late 1990s. Levels of new bank formation have been particularly high in the **Grand Rapids, Las Vegas, Naples, Phoenix, Portland, Salt Lake City, Sarasota,** and **Seattle** markets.

Economic conditions in some of these markets may have weakened somewhat from the generally optimistic expectations that developed during the strong expansions in the late 1990s. Portland and **San Jose,** for example, already appeared to be in localized contractions by midyear 2001 because of considerable exposure to a weak high-tech manufacturing sector. **Atlanta, Memphis, Orlando,** and Phoenix also reported substantial slowing during 2000. Additionally, certain of the identified markets have high economic exposure to sectors that could be adversely affected by the national economic downturn. Las Vegas and Orlando remain heavily dependent on tourism, while markets with heavy exposure to a weakened air transportation sector, such as **Fort Worth** and Memphis, will be affected by reduced air travel and air cargo shipping. Also, real estate markets in many of these areas may be vulnerable to supply/demand imbalances as the economy slows.[34]

Obviously, other banking markets are not immune to the risks posed by a national economic downturn. In fact, many other markets share some of the same characteristics that may result from dynamic economic growth and rising credit exposure. Most of these additional metropolitan area markets are in the Southeast and West. Few are in the Northeast, an area of the country that was hit hard during the 1990–1991 recession (see box for a discussion of metropolitan areas at risk in the late 1980s).

Rapid growth and the acceptance of heightened levels of credit risk during the recent expansion enabled many banks to achieve extraordinary levels of profitability. However, the strategies, policies, and practices that were implemented during a more vibrant economy may not be appropriate today. Just as past economic strength in many metropolitan markets allowed banks more latitude in underwriting standards and credit administration practices, the current economic downturn suggests the need for increased attention to risk management functions.

Robert Burns, Senior Financial Analyst
Lisa Ryu, Financial Economist

[33] Noncore funding sources include brokered deposits, certificates of deposit of $100,000 or more, Federal Funds purchased, securities sold subject to repurchase agreements, and other borrowed funds. The latter category consists largely of Federal Home Loan Bank advances.

[34] Real estate market conditions for many of these markets are discussed in “Slowing Economy Reduces Demand for U.S. Office Space,” *Regional Outlook,* third quarter 2001. Some metropolitan areas were not considered in the analysis of real estate conditions because of limitations in real estate data availability; therefore, omission from this list does not suggest that specific real estate markets are not vulnerable.

Why Focus on Economic Activity, Loan Growth, and Credit Exposure?

While the banking sector has evolved with the emergence of new business models, some lessons gleaned from the past may still hold true. During previous economic downturns, banks and thrifts operating in areas of the country that previously had exhibited the most rapid rate of growth were often the most severely affected by a downturn. A 1997 study[35] of banking crises in the 1980s and early 1990s described some common characteristics of insured financial institutions most affected by economic downturns:

- Bank failures generally were associated with regional downturns that had been preceded by rapid regional expansions. This pattern of "boom-bust" economic and banking activity was evident first in banking markets in the Southwest, then in the Northeast and California.
- During periods of local economic expansion, many banks pursued a strategy of aggressive loan growth in response to strong credit demand, leading to relatively high credit exposure.
- Banks that failed during subsequent downturns generally had higher credit exposure than banks that survived.

A review of metropolitan markets in the late 1980s, using the methodology described in this section,[36] would have revealed a much more geographically concentrated list of markets than depicted in Map 1. These markets were primarily in the Northeast and in California. During the subsequent five-year period, banks headquartered in these markets failed at over two and a half times the national rate (4.7 percent for banks meeting the sample criteria).

- Markets in the Northeast that would have been identified at year-end 1988 using the previously described methodology include **Bergen, Boston, Hartford, Monmouth, Nassau-Suffolk, Newark, New Haven, Portsmouth,** and **Providence.** Banks in these markets experienced an 18 percent failure rate in the subsequent five-year period.
- Markets in California that would have been identified include **Fresno, Los Angeles, Orange County, Riverside,** San Jose, and **Ventura.** Banks in these markets experienced an 11.3 percent failure rate during the subsequent five-year period.
- Markets elsewhere in the nation that would have been identified are concentrated in the Southeast and include Atlanta, **Charlotte, Macon,** Phoenix, Sarasota, and **Tallahassee.** Banks in these markets experienced an 8.8 percent failure rate in the subsequent five-year period.

However, not all of the identified markets in 1988 experienced a high rate of bank failures in the subsequent recession. For example, none of the sampled banks in the Nassau, Fresno, or Ventura metropolitan markets failed during the five-year period after 1988. Likewise, not all banking markets that report elevated risk profiles today will necessarily experience serious problems during the current downturn.

[35] 1997. Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Volume I: An Examination of the Banking Crises of the 1980s and early 1990s.* Washington, D.C.: Federal Deposit Insurance Corporation.

[36] The analysis of potentially vulnerable markets in 1988 did not include savings institutions because of inherent data limitations and the overall condition of the thrift industry at that time.

Atlanta Regional Perspectives

Declining Economic Growth and Implications for the Atlanta Region

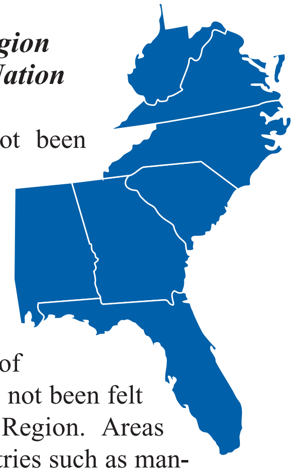
The Atlanta Region economy does not exist in isolation and, consequently, can expect growth to be influenced by national and global conditions and specific events, such as the September 11, 2001, terrorist attacks. Over the past several quarters, growth, both nationally and internationally, has declined. The following analyzes the current economic slowdown in the context of recent history and attempts to determine what impact it has had on the Atlanta Region economy and, ultimately, what challenges the Region's banking industry may face.

The Recent National Slowdown and Comparisons with History

At the time this article was written, the nation's slowdown had not been classified by the ***National Bureau of Economic Research*** as recessionary. However, several indicators illustrate the current weakness in the nation's economy. Real gross domestic product figures indicate that growth declined significantly over the past several quarters and, by second quarter 2001, the economy expanded at an annual rate of just 0.3 percent. Another sign of the nation's weakening economic health is the upward trend in unemployment rates, which is typically a leading indicator of a recession.[1] The nation's monthly unemployment rate was above year-ago levels for eight consecutive months through August 2001. Since the 1950s, every period of year-over-year rising unemployment rates lasting more than six months has coincided with a recession. Although the unemployment rate remained below 5 percent through the summer of 2001, history shows that jobless rates at the outset of some recessions started at even lower levels. Moreover, the unemployment rate has risen by a full percentage point, from 3.9 percent to 4.9 percent. During the post-World War II era, no such increase has occurred without the economy being in recession. Even without a recession, sustained weakness may result in some measure of distress as the banking industry adjusts to a lower level of economic growth.

[1] Mark, Roger R. 1998. *Handbook of Key Economic Indicators,* 2nd Edition. McGraw-Hill, p. 32.

Growth in the Atlanta Region Slows but Outpaces the Nation



The Atlanta Region has not been immune to the effects of slowing growth nationally and globally. Since late 2000, economic growth in the Region has declined, but it remains above the national rate. However, the effects of weaker national growth have not been felt uniformly throughout the Region. Areas with concentrations in industries such as manufacturing and high-tech businesses have experienced the most dramatic declines in growth. These areas have been affected further as the effects of sectoral downturns have radiated throughout the local economies. In contrast, other areas of the Region continue to experience comparatively strong levels of growth as economic diversification or industries that have not experienced a downturn have bolstered the local economies.

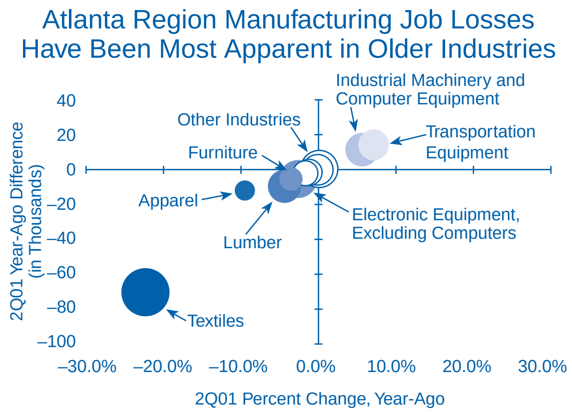
Traditional Manufacturing: An Ongoing Area of Distress

Initially, much of the nation's slowdown has been concentrated in the manufacturing sector—a critical area of prolonged weakness in the Atlanta Region. Nationwide, 14 percent of the workforce is concentrated in manufacturing. The percentage of the labor force employed in manufacturing is significantly higher in ***North Carolina, Alabama, South Carolina,*** and ***Georgia.*** Until recently, the erosion in the Region's industrial base has proceeded at a faster pace than the nation. One reason for this higher rate is the fact that nearly half the manufacturing employment in the Region is in nondurable goods[2] production—where losses have occurred at a much higher rate[3]—compared with 40 percent

[2] Nondurable goods manufacturing includes food products, tobacco, textiles, apparel, paper, printing and publishing, chemicals, petroleum and coal products, rubber and plastics, and leather. Durable goods production includes lumber and wood; furniture, stone, clay, and glass; primary and fabricated metals; industrial machinery and equipment; electronic equipment; transportation equipment; instruments; and other miscellaneous manufacturing.

[3] During the period April 2001 through August 2001, however, the year-ago rate of manufacturing employment erosion nationally eclipsed that in the Atlanta Region as losses in durable goods industries accelerated.

CHART 1



Note: Size of bubble represents relative size of industry
Source: Bureau of Labor Statistics (Haver Analytics), DRI-WEFA

nationwide. By a wide margin, the Region's largest manufacturing subsector is textiles, which lost more than 70,000 jobs (22.5 percent of the sector's total) over the year ending second quarter 2001 (see Chart 1). Although employment has been declining for several years, such factors as slowing global growth and the strength of the U.S. dollar have exacerbated the sector's ongoing weakness. The Atlanta Region's unique industrial mix—which includes high exposures in nondurables production and in other traditional industries, such as lumber and furniture—has resulted in a much higher rate of job loss compared with the nation.

High-Tech Manufacturing and "Dot-Bombs"

While losses in traditional manufacturing have had an ongoing effect, the Atlanta Region, like the nation, benefited substantially during the 1990s from rapid growth in high-tech industries[4] (both manufacturing and service based). During the 1990s, the Region's high-tech employment swelled by nearly one-third compared with the national increase of 20 percent. ***Northern Virginia, Atlanta, Raleigh, Tampa, Orlando, Miami, Charlotte, Norfolk,*** and ***Huntsville*** are the Region's large urban area high-tech employers. As recent high-tech layoffs in several of these markets and declines in the NASDAQ illustrate, however, that the high-tech industries are not immune to downturns. Those areas that have experienced "booms" in high-tech growth in recent years also may be susceptible to "busts" if the slowdown in these industries persists.

Exposure to More than One Stressed Industry May Pose Greater Economic Risk to Local Economies

Economic conditions in local economies may be further aggravated if stress occurs simultaneously in multiple industries. Such a scenario emerged during late 2000 and 2001 in the ***Hickory, North Carolina,*** metropolitan area and surrounding counties, where the local economy has been dominated by manufacturing, which accounted for 40 percent of total employment in 2000. This reliance, historically, has been concentrated in traditional industries such as textiles, apparel, and furniture manufacturing. However, during the 1990s, the local economy diversified into telecommunications equipment (fiber optic and coaxial cable) manufacturing. By mid-2000, strong job growth had helped lower the area's not-seasonally-adjusted unemployment rate to just under 2 percent. Later that year, however, the economy began to soften as layoffs emerged in traditional industries. Already weakening economic conditions were exacerbated by the surprise job losses in cable manufacturing—an industry thought by many local residents to be "slowdown-proof."[5] Subsequently, labor market conditions deteriorated rapidly, with the jobless rate rising from less than 3 percent in July 2000 to 7.2 percent one year later. The nearby ***Greensboro*** metropolitan area also has experienced deteriorating economic conditions for similar reasons. The events in Hickory and Greensboro illustrate how fast and to what depth economic conditions can deteriorate given retrenchment in multiple key industries. Insured institutions in both metropolitan areas may be starting to feel the effects of this deterioration. Community bank[6] performance, as measured by median return on assets, declined somewhat during the first half of 2001 from a year earlier, while nonaccruals and charge-offs have increased.

[4] For the purpose of this analysis, we use primarily a *DRI-WEFA, Inc.,* definition based on multiple standard industrial codes (SICs), which includes: drugs (SIC 283), computer and office equipment (SIC 357), communications equipment (SIC 366), electronic components and accessories (SIC 367), aircraft and parts (SIC 372), guided missiles, space vehicles, and parts (SIC 376), search and navigation equipment (SIC 381), measuring and controlling devices (SIC 382), medical instruments and supplies (SIC 384), telephone communications (SIC 481), computer and data processing services (SIC 737), motion picture production and services (SIC 781), engineering and architectural services (SIC 871), and research and testing services (SIC 873).

[5] Hager, George. July 30, 2001. "Hickory, NC: Struggling Town Showcases Slowdown's Impact." *USA Today.*

[6] Locally headquartered commercial banks with assets less than $1 billion.

The Multiplier Effect? Service-Producing Industries and Real Estate Markets

Fallout from layoffs in manufacturing and high-tech industries has had a limited effect in the more diversified local economies in the Atlanta Region, primarily in larger metropolitan areas, which have absorbed losses and continued to expand. However, if the effects of these losses begin to radiate into previously unaffected sectors of the economy, via falling demand for goods and services, or if consumer confidence wavers further, growth could become constrained and have a greater impact on the banking industry.

The real estate market is one area that is experiencing weakness because of the slump in manufacturing and high-tech industries. In Virginia's ***Dulles Corridor,*** for example, office vacancy rates in ***Herndon*** and ***Reston*** quadrupled in second quarter 2001 from one year earlier as negative absorption rose in early 2001. Residential real estate markets may also be vulnerable as continued slow economic growth could surprise homeowners and lenders who have grown accustomed to a rapid pace of home price appreciation in recent years.[7]

Local economies that had, until now, remained somewhat immune to the weakening economy may be affected if slow growth persists. One such industry could be tourism, if consumer confidence continues to slip, spending slows, or consumers postpone or cancel travel plans in light of the national tragedy of September 11, 2001. Areas such as ***Orlando*** could be negatively affected if such a situation emerges, particularly given the level of expansion in the hospitality-related industry that this metropolitan area experienced during the 1990s.

Banking Implications

Credit quality may be weakening in some areas of the Atlanta Region. This trend is most evident among banks in states such as Alabama and North Carolina, which to date have experienced the greatest degree of economic slowing. In Alabama, for example, this slowing is highlighted by increasing levels of mortgages 90-days or more past due and foreclosures started, which have eclipsed levels reached during the last recession. The weakness in consumer credit quality, in part, may result from the recent increases in personal bankruptcy filings.[8] Record consumer debt burdens coupled with mounting layoffs could adversely affect consumer credit quality among the Region's banks and thrifts. Commercial credit quality at insured institutions in North Carolina also has weakened. Levels of delinquent commercial real estate and commercial and industrial loans have increased each quarter since second quarter 2000. Insured institutions in other areas of the Region may experience similar declines in commercial credit quality if business conditions continue to deteriorate.

In addition to credit quality issues, continued economic weakness could adversely affect industry profitability in other ways. For example, loan growth likely will slow along with the economy. Already, survey reports indicate that demand for new commercial and industrial loans from small and large borrowers is declining.[9] Moreover, consumers may scale back borrowing, particularly if consumer confidence deteriorates. Margins also likely will be pressured by the dramatic fall in short-term interest rates, as there is little downward repricing opportunity for nonmaturity deposits at many insured institutions.

The operating environment for the industry may be the most challenging it has been in a decade. Many insured institutions report comparatively high levels of concentration in their business lines. A large number of these institutions are located in areas that have previously experienced rapid economic growth. A moderation in the pace of expansion in these markets could surprise some borrowers and lenders who expected above-average levels of growth to continue. Now that economic growth is moderating, it may be prudent to lower expectations and give careful consideration to the selection of appropriate lending concentration levels.

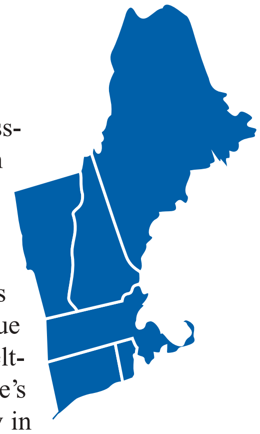
Atlanta Regional Staff

[7] Fletcher, June. September 5, 2001. "Slowdown Threatens Residential Real Estate." *Wall Street Journal.*

[8] Some of the increase, however, may be attributable to proposed legislation that would make it more difficult to file for bankruptcy.

[9] Federal Reserve Board. August 2001. *Senior Loan Officer Opinion Survey.*

Boston Regional Perspectives



The Region's Economy Will Follow the Nation's through the Current Downturn

Following the events of September 11, 2001, it is increasingly likely that the nation's and Boston Region's economies have entered a period of economic retrenchment. As of this writing, factors that will have a significant effect on economic growth through mid-2002 were continuing to evolve. However, even before September, the Region's economy had shown signs of slowing. For example, the Region's seasonally adjusted unemployment rate had risen to 3.8 percent in September, from an expansion low of 2.4 percent in December/January. Third quarter nonfarm job growth for the Region (on a year-ago basis) was also lower than it has been since late 1992. The heated advance in U.S. equity markets between late 1994 and March 2000 allowed many of the Region's households to accumulate significant wealth in their investment portfolios and to boost their spending, but a weak stock market since then has likely hampered consumer expenditures. However, lower mortgage rates should continue to support cash-out refinancing activity in the near term, allowing many home-owning households to partially offset declines in stock portfolio wealth or a disruption in income caused by the weaker economy.

Certain States and Sectors Are Expected to Show Greater Stress

Even before September 11, the Region was grappling with a secular decline in its significant information technology (IT) sector. The loss of jobs and income from this adjustment (which is expected to continue as long as the economy remains weak) likely will be amplified during the coming months. The events of September 11 and their aftermath have affected several industries negatively, both in the Region and nationally, with the added risk of further deterioration through early next year. These industries include air travel, commercial aerospace manufacturing, tourism-related businesses, insurance, and securities, many of which are large employers in the Region. Among the states in the Region, **Connecticut** has large concentrations of employment (or domiciled workers) in commercial aerospace, insurance, and securities. The state's tourism industry (including its large tribal casinos), which is largely dependent on local drive-in traffic, should not be as exposed as tourism businesses in other parts of the nation that rely heavily on fly-in visitors.

Although **Massachusetts** has experienced (and will continue to bear) the brunt of the IT meltdown in the Region, the state's securities industry is primarily in the form of asset management firms, which may be less affected by a downturn in the securities sector than more-traditional Wall Street firms. Beyond the immediate drop in tourism and convention volume in September, the ultimate effect on the Region's tourism industry is unclear. In general, a slowing economy is usually not positive for the cyclical tourism industry. However, an aversion to flying may result in more skier visits to New England this winter by Northeasterners who typically might fly to other destinations, thus offsetting some of the cyclical weakness expected at local resorts.

Office Markets around Boston Evidenced Some Cooling

Office real estate conditions worsened in the Boston Region during third quarter 2001. Office vacancy rates in **Boston** and **Cambridge** continued to increase as blocks of sublease space were returned to the market as a result of the slowdown in the IT sector. In the Cambridge submarket (which had held a high concentration of Internet firms), some estimates put current vacancy rates at their highest level since the recession in 1991. As a whole, Boston is faring better, but suburban vacancy rates (between 10 and 17 percent) are well above those for the financial district. Also, in downtown Boston, about 2 million square feet (roughly 4 percent of reported multitenant inventory) was on the market to be sublet through third quarter 2001—more than the total amount absorbed in 2000. According to the commercial real estate firm ***Meredith & Grew Inc.,*** average rents have leveled off at $50 to $65 per square foot for Class A space, following steady increases through 2000. Boston-area industrial markets, particularly in the suburbs, continue to exhibit low vacancy rates. Hotel space remains in short supply around greater Boston, but demand, which was already softening as economic growth slowed, was curtailed even more following the September 11 attacks. Occupancy rates at downtown Boston hotels are falling, and many conventions planned in the city have been canceled or rescheduled.

Office vacancy rates in **Stamford,** Connecticut (and for all of **Fairfield County**) have increased significantly since year-end 2000. However, demand for the area's roughly 5 million square feet of unoccupied office space may increase because of recent events. The attacks in New York City removed 13 million square feet of office space and damaged another 16 million.[1] Many displaced companies are relocating to Fairfield County and northern New Jersey, absorbing blocks of available space in each market. While long-term effects are unclear, this relocation may reduce office vacancy rates in Fairfield County, at least in the near term.

The Region's Banks Are Better Prepared for this Economic Downturn...

The Region's insured institutions enter this period of economic weakness in much better condition than was the case in 1990. Before the last recession, the New England economy was already weakening, and the overall condition of the banking industry reflected that weakness. As of June 30, 1990, the date that marked the beginning of the last recession, approximately 30 percent of the Region's insured institutions, comprising 58 percent of total assets, already had composite capital, assets, management, earnings, and liquidity (CAMELS) ratings of 3, 4, or 5. These percentages had been rising steadily since mid-1987, and by 1991, 58 percent of the banks, and nearly 70 percent of the Region's total assets, carried less than satisfactory CAMELS ratings. However, as of June 30, 2001, just 5 percent, by both count and total assets, were assigned to the weaker rating bands, suggesting that we will enter this downturn from a position of relative strength.

The improved health of the industry today is reflected in capital and reserves levels as well. The median ratio of capital and reserves to total assets has risen approximately 200 basis points since the late 1980s to nearly 10 percent today. More important, the asset mix of the Region's insured institutions is decidedly less risky than in the late 1980s. During that time, nearly 75 percent of all institutions had loan-to-asset ratios in excess of 70 percent. Today, fewer than 40 percent have similar ratios. Additionally, insured institutions have reduced exposure to historically high-risk loan categories (commercial and industrial, commercial real estate, and construction and development). In 1990, approximately 20 percent of all institutions had concentrations of investment in high-risk loans exceeding 600 percent of Tier 1 capital. Those institutions had a failure rate six times greater than institutions with high-risk loan concentrations under 400 percent of Tier 1 capital. Today, just 4 percent of the Region's banks and thrifts report concentration levels over 600 percent of Tier 1 capital; only 14 percent exceed the 400 percent threshold.

...but Earnings Will Remain under Pressure...

While the overall condition of the Region's banks is generally favorable heading into this economic downturn, several factors suggest that an elevated level of caution is warranted. First, earnings have been on a slow, steady decline since 1997, largely because of net interest margin erosion. The sharp decline in interest rates that began in January 2001 has accelerated the rate of earnings decline, as banks have been unable to bring down funding costs as rapidly as earning asset yields have fallen. Even traditionally "liability-sensitive" savings banks are feeling the squeeze because savings, NOW (negotiable order of withdrawal), and money market deposit rates, which were already low relative to market interest rates, had little room to move on the downside. Additionally, a renewed refinancing wave has pushed down asset yields much faster than was expected. This trend will likely persist into early 2002 as further rate cuts have driven refinancing activity to record levels. The sharp drop in short-term rates also will have a negative effect on commercial bank margins, particularly those of banks that have a high percentage of loans priced off variable indices such as the prime rate.

Additionally, the quality of bank earnings has diminished as many insured institutions have supported bottom-line profits by taking securities gains and reducing loan loss provisions to offset the decline in margins. While asset quality indicators remain highly favorable throughout the Region, modest deterioration is beginning to show in the form of rising delinquencies in rural areas, as well as continued deterioration in the commercial and consumer portfolios of nationally focused institutions. This trend is expected to continue, and institutions now face the prospect of building loan loss reserves for the first time in years. Also, the loan losses

[1] September 18, 2001. Grubb & Ellis Special Report. "NYC's Office Market—Assessing the Damage."

that will be realized during this downturn are, for the most part, already embedded in the portfolios of the Region's banks. Institutions that aggressively manage their portfolios from both a credit administration and a collection perspective will minimize potential loss exposure; however, the costs to carry out these functions effectively will put additional pressure on earnings. Finally, while securities gains will be available in this lower rate environment, the reinvestment process will put further downward pressure on net interest margins.

Continued erosion of net interest margins, higher loan loss provisions, and reduced prospects for new business opportunities resulting from a slowing economy (which will stifle growth and reduce transaction-based income sources) will continue to chip away at earnings in the short term. This situation will lower institutions' capacity to absorb any significant credit shock should the recession be deeper or longer than expected, underscoring the importance of maintaining strong loan portfolio management practices to minimize credit losses.

...and Longer-Term Interest Rate Risk Exposures Are Poised to Rise

The refinancing wave of the late 1990s exerted a significant effect on the interest rate risk profiles of the Region's savings banks. Among these institutions, there was a wholesale shift in the composition of residential loan portfolios from predominantly adjustable-rate mortgages (ARMs) to heavier concentrations in fixed-rate loans. As a result, there has been a significant increase in the number of institutions with concentrations in long-term assets (over five years). In the mid-1990s, fewer than 25 percent of all savings banks reported long-term assets exceeding 30 percent of earning assets. By year-end 1999, more than 70 percent of savings banks had reached this concentration level, and it has remained relatively constant. The current refinancing wave already has exceeded the 1998 wave in magnitude and likely will have a disproportionate effect on ARM holdings once again. Reinvesting prepayments from both loan and securities portfolios will be a difficult balancing act of mitigating margin erosion to the extent possible without jeopardizing future earnings prospects through undue concentrations in long-term assets. While the prospects for higher interest rates appear remote at present, rates will rise eventually, particularly short-term rates that drive the bulk of bank funding costs. Insured institutions should be positioned for this eventuality.

While usually not sufficient on its own to undermine earnings or capital, significant interest rate risk exposure could weaken a bank's earnings capacity at exactly the wrong time, making it more susceptible to other adverse shocks, such as a downturn in credit quality or a large-scale fraud. Sound interest rate risk management should preclude such an occurrence by ensuring that a bank's earnings stream is not affected unduly by fluctuating interest rates.

Boston Regional Staff

Chicago Regional Perspectives

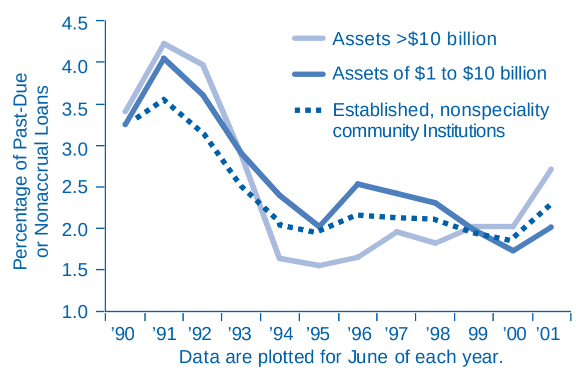
Loan Quality Pressures Become More Widespread in the Region

Slowing economic conditions have started to affect loan quality in nearly every banking line of business. Indicators of loan performance have experienced deterioration, which could become more pronounced should loan demand continue to soften. The Chicago Region's insured financial institutions experienced increasing levels of past-due and nonaccrual (PDNA) loans in the year ending June 30, 2001. For several years, PDNA ratios have risen at the Region's largest institutions (see Chart 1). This development follows a national trend in which shared national credits are playing a large role in the deterioration of credit quality.[1] The past year's upturn in PDNA ratios at the Region's banks and thrifts with assets of $10 billion and less reverses trends of recent years. This article examines credit quality developments at the Region's established community institutions[2] among which the aggregate PDNA ratio rose to 2.31 percent on June 30, 2001, from 1.85 percent a year earlier.

Among community institutions, the most pronounced deterioration, as gauged by the June 2001 PDNA ratio relative to the prior five-year average, occurred in the one-to-four family and commercial real estate loan (CRE) categories. The PDNA ratios for these lending segments are about 25 percent higher than the five-year averages, while charge-offs for these lines are approximately twice the average over the last five years. Commercial and industrial (C&I) loan quality also warrants attention, given the higher PDNA and charge-off rates and the fact that this loan category represents nearly 15 percent of total loans at the Region's community institutions (see Table 1).

Chart 1

Past-Due and Nonaccrual Loan Ratios Are Rising at Chicago Region's Insured Institutions



Source: Bank and Thrift Call Reports

Loans to Household Sector Show Moderate Increases in PDNA Ratios

Loans to consumers, including credit cards and home equity lines of credit, have shown some weakness in credit quality as the financial vibrancy of the household sector has waned. Some trends behind this weakening, which could affect households' financial cushions and repayment abilities, include the following:

- Regional job growth decelerated to zero at midyear 2001 from 1.8 percent a year earlier. A 3.1 percent drop in manufacturing jobs and a noticeable slowdown in hiring by other sectors drove this deceleration. The Region's unemployment rate rose to 4.6 percent at mid-year 2001 from 3.9 percent one year earlier.
- Rates of home price appreciation have varied considerably among communities. In those where it has been sizeable, new and refinanced mortgages based on recent sales valuations could be exposed to some erosion of collateral value as overall economic conditions weaken. In addition, some households undertook cash-out refinancing just before the economic slowdown became evident, and their increased leverage could heighten their vulnerability to any adverse events such as reduced hours of work or job layoffs.
- Personal bankruptcy filings in the Region's states during the second quarter, 2001, were 28 percent to 42 percent higher than a year earlier, compared with a 25 percent increase nationally. This year's surge likely reflects financial strains among a growing number of households as well as the impetus earlier this year to accelerate filings before the potential passage of legislation to tighten bankruptcy terms.

[1] For more details, see "Emerging Risks in an Aging Economic Expansion," FDIC Regional Outlook, fourth quarter 2000, pp. 6-8.
[2] Community institutions are defined as banks and thrifts that have been in existence at least three years with assets of $1 billion or less, exclusive of credit card and other specialty institutions.

Residential Real Estate: Typically, single-family mortgages have been associated with low loss rates compared with other lending lines at insured institutions. Although charge-offs remain low, the risk profile of residential real estate (RRE) portfolios may be changing. As competition for conventional mortgages heightens, profitability on these loans will remain thin. Institutions may choose to increase exposure to unconventional borrowers or nonconforming property types to offset margin compression. Furthermore, to the extent that loans meet the conventional criteria and are sold, community banks and thrifts could potentially be left with a less diversified and riskier mortgage portfolio. Some weakness in the loan quality of the Region's residential loan portfolio already is apparent as the past-due ratio in the one-to-four family loan segment rose to the highest level in a decade.

Commercial Lines Begin to Show Signs of Strain

Commercial Real Estate: For the past several years, robust economic activity has led to a resurgence of commercial real estate (CRE) lending and overall improved asset quality measures among insured financial institutions. However, as slowing economic conditions curtail business expansion, weakness in certain commercial real estate markets has led to softness in CRE loan performance. Despite some slowing, CRE loan growth remained at a strong 17 percent over the past year. During this period, PDNA CRE loan ratios at community banks and thrifts rose appreciably, though charge-offs remained low. The bulk of this deterioration was experienced by the 14 percent (222) of the Region's community institutions that had at least 200 percent of Tier 1 capital concentrated in CRE loans and that reported a CRE loan growth rate of 20 percent or more over the past year. **Michigan** and **Wisconsin** were home to the highest percentage of banks and thrifts with this level of growth and concentration. A significant number of these institutions are headquartered in the **Grand Rapids** and **Madison** metropolitan statistical areas (MSAs).

While growth in most loan categories subsided, construction and development (C&D) lending continued at a rapid clip; however, this category represents only a small portion of total loans. Nevertheless, C&D loan portfolios may be the most vulnerable CRE component during a slowing economy. Of the three classes of CRE credits, C&D loans experienced the greatest deterioration during the 12-month period ending June 30, 2001.

As preleasing commitments falter with the slowing economy, construction projects financed on a speculative basis, without meaningful presale, prelease, or takeout commitments, could face even greater challenges in a downward cycle. According to the most recent ***FDIC Report on Underwriting Practices,***[3] the proportion of banks nationally that either "frequently"

Table 1

Loan Performance of Community Institutions Shows Some Weakening

Type of Loan	Past-Due and Nonaccrual Loans (%)		Loans Charged Off (%)		Loan Growth (percentage change from year earlier)		Loan Mix (percentage of loan portfolio)	
	June 30, 2001	June 30, 2000	June 30, 2001	June 30, 2000	June 30, 2001	June 30, 2000	June 30, 2001	June 30, 2000
Commercial & Industrial	3.42	2.97	0.50	0.42	9.4	18.1	14.4	14.1
Consumer	2.72	2.24	0.54	0.41	–1.5	8.0	8.7	9.4
1-to-4 Family Residential	2.16	1.69	0.04	0.02	2.1	12.2	39.0	41.1
Agricultural*	2.11	3.11	–0.02	0.00	6.7	11.6	5.7	5.9
Commercial Real Estate	2.08	1.42	0.06	0.03	17.4	20.3	26.9	24.6
Construction & Development	2.64	1.89	0.02	0.01	28.8	23.4	5.3	4.4
Nonresidential	2.07	1.39	0.08	0.04	14.7	20.2	18.6	17.4
Multifamily	1.19	0.92	0.01	0.07	16.6	15.8	3.1	2.8
Home Equity Lines	1.16	0.79	0.03	0.05	1.6	8.5	3.5	3.4

*Consists of farm real estate and agricultural production loans
Source: Bank and Thrift Call Reports (aggregate data, excluding de novo and specialty institutions)

[3] *FDIC Report on Underwriting Practices.* March 2001.

or "commonly" made speculative construction loans rose from 26 percent to 29 percent over the six-month period ending March 31, 2001. The use of higher-risk lending practices, such as deferred interest payments and no equity financing, also increased during the latest survey period.

In the Chicago Region, 100 community institutions were identified at midyear as having at least 100 percent of Tier 1 capital concentrated in C&D loans, up from 80 at June 30, 2000. Seventy percent of these institutions reported a C&D loan growth rate above 20 percent for the period, making them potentially more vulnerable to continued economic weakness. As unemployment rates rise and economic growth slows, insured institutions experiencing this level of growth and concentration, particularly those in MSAs that are experiencing rising vacancy rates or increasing inventories of homes for sale, may realize further deterioration in C&D loan performance. Subsequently, overall CRE loan quality also may decline somewhat as the adverse effects of this combination of risk factors affects insured institutions throughout the Region. **Chicago** and **Indianapolis** are examples of metropolitan areas that are experiencing rising CRE vacancy rates at the same time insured institutions are increasing exposures to these traditionally higher-risk loan categories.

Commercial and Industrial: In addition to the more relaxed underwriting standards of the past, recent national trends, such as falling corporate profits and increased leverage, may be negatively affecting commercial and industrial (C&I) loan performance at community banks and thrifts. At June 30, 2001, PDNA C&I loans at the Region's community institutions grew to 3.42 percent, the highest level since third quarter 1998. C&I charge-offs remained low but rose 8 basis points during the past 12 months to 0.50 percent, the second consecutive annual increase.

One way to assess the potential risk associated with C&I lending is to look for a combination of C&I loan concentration relative to Tier 1 capital and rapid C&I loan growth. Institutions that have exhibited these characteristics in the past have generally experienced greater loan quality deterioration than other institutions. At midyear 2001, 230 institutions, or 14 percent of community banks and thrifts in the Region, reported a C&I concentration over 100 percent of Tier 1 capital and rapid C&I loan growth (20 percent or more over the past year); these institutions accounted for roughly 33 percent of the Region's total C&I exposure. Ninety-eight (43 percent) of these institutions are headquartered outside an MSA. In the aggregate, loan quality at these institutions deteriorated somewhat, as the PDNA ratio for C&I loans rose to 2.97 percent by June 30, 2001, from 2.70 percent a year earlier. Charge-offs increased by 11 basis points to 0.36 percent. Nonetheless, this group's C&I loan portfolio outperformed that of other community institutions in the Region. To compare, community institutions holding lower concentrations reported a C&I charge-off rate of 0.56 percent and a PDNA ratio of 3.63 percent, up 48 basis points from a year earlier.

Despite the evidence of slight weakening in C&I credit quality, the strong C&I loan growth at the 230 institutions may be masking the full extent of deterioration in loan quality. While most community banks and thrifts have reduced C&I loan exposure, the percentage of C&I loans held by the 230 institutions mentioned above rose to 24 percent of total loans by June 30, 2001, an increase of 400 basis points from June 30, 2000. Meanwhile, the percentage of C&I loans to total loans for other banks and thrifts in the Region fell noticeably, to 12 percent. However, the C&I lending concentrations held by the 230 institutions may accompany a level of management experience and expertise as well as portfolio diversification that helped mitigate the level of credit quality deterioration during the past year. Nonetheless, should economic weakness persist and business conditions continue to wane, these institutions could experience a rapid deterioration in credit quality that could become more apparent as loan demand slows.

Shocks from September 11 May Extend the Depth and Length of Economic Weakness, Exacerbating Loan Quality Issues

The probability of prolonged economic weakness has increased, in part because of economic disruptions related to the events of September 11. Should weakness continue, recent loan quality deterioration will likely become more pronounced. During the recession of the early 1990s, C&I and CRE loan quality deteriorated significantly, as measured by charge-off and delinquency levels. Since then, community banks have increased loan-to-asset levels and relative exposures to these historically riskier loan categories. The continued slowdown in business activity and increasing vacancy rates will likely keep commercial loan demand soft, moderating exposure to those categories in the near term. However, given the current relatively high exposures to these lending segments, pressure on loan quality will likely continue in the presence of sustained economic weakness. In addition, recent residential real estate loan performance illustrates that some traditionally lower-risk loan segments may not perform as well during the current slowdown. Whether collateral on these loans remains sufficient will be a function of the extent to which consumers and banks have used cash-out refinancings or high loan-to-value ratios, as well as the health of residential real estate markets.

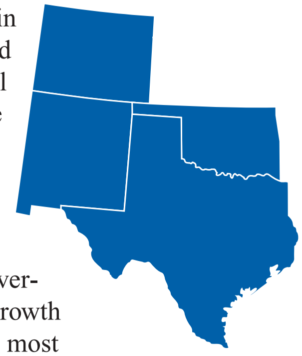
Chicago Regional Staff

Dallas Regional Perspectives

Shifting Economic Outlook. The economy of the Dallas Region has slowed during the past two years from a robust to a modest level of growth. An anemic national economy and an ailing high-tech sector have contributed significantly to this rapid slowing in job growth.

Before the attacks of September 11, 2001, economic indicators for the nation, including the Dallas Region, were suggesting an increased likelihood of recession. In the attacks' aftermath, there may well be additional negative repercussions on the spending patterns of consumers, businesses, and investors, and thus on the economy. As an indication of the potential for a decline in consumer spending (which to date has been a source of strength for the national economy), the results of a ***University of Michigan*** survey of U.S. consumer sentiment taken one day *before* the terrorist attacks showed a decline from 91.5 in August to 83.6 in September.[1] Following the attacks, the ***Conference Board's*** Consumer Confidence Index plummeted to 97.6 in September from a revised 114.0 in August—the largest drop since the Persian Gulf War.[2]

In the context of the ongoing uncertainty about the outlook for the economies of the nation and the Region, this article focuses on the overall deterioration in the Region's economy since the beginning of 2001, particularly as it relates to stress in the high-tech industry and effects on the commercial real estate sector and the banking industry.



Employment Growth Decelerates. Table 1 compares the Region's annual average nonfarm employment growth from 1993 to 2000 with the most recent year-to-year figures (July 2001). Job growth for all four states in the Region showed a marked deceleration—34 percent to 60 percent below previous trends. Both **Colorado** and **Texas,** which together account for 84 percent of the Region's total nonfarm employment, have experienced substantial slowing in job growth rates since February 2001, dragging down the Region's employment growth.

High-Tech Manufacturing and Government Are the Weak Links in the Region's Economy. Manufacturing job losses have accelerated. Declining sales, falling prices, and shrinking profits have plagued the high-tech capital goods and telecommunications industries. In addition, government agencies are paring payrolls. Slowing economic growth has affected revenue growth at all levels of government but particularly at the state

Table 1

Employment Growth in the Dallas Region Has Fallen Well below Trend

	Dallas Region Employment Growth Rates by State			
States	Annual Average (%) Rates of Growth, 1993–2000	Year-to-Year Rates of Growth, July 2000/2001 (%)	Difference (Basis Points)	Difference (% Change)
Colorado	4.17	1.65	-252	-60
New Mexico	2.70	1.71	-99	-37
Oklahoma	2.47	0.99	-148	-60
Texas	3.33	2.20	-113	-34

Source: Bureau of Labor Statistics

[1] September 2001. University of Michigan survey of U.S. consumer sentiment.

[2] According to the Conference Board's website (http://www.conference-board.org), "survey results (for the September survey) conducted *before* and *after* the terrorist attacks on September 11 differed slightly, there was no reversal in the downward trend of the Index."

and local levels, resulting in budget cutbacks and reduced employment. Both sectors combined for 28 percent of the Region's total nonfarm employment as of second quarter 2001.

Many market analysts believe that the telecommunications industry is currently experiencing significant excess capacity and an overhang of corporate debt, precluding an economic turnaround in that sector any time soon. Large high-tech regional employers—such as Dell, Nortel, Texas Instruments, Ericsson, Compaq, Nokia, and Qwest—have issued major layoff announcements in 2001, in some cases more than once. Major high-tech metropolitan statistical areas (MSAs), such as Denver and **Dallas,** have lost thousands of high-paying high-tech jobs and seen employment growth rates fall well below trends of the past eight years. Mid-sized MSAs that depend even more on the high-tech sector or exhibit comparatively less diversification are hurting even more. MSAs in this category include **Austin, Albuquerque, Colorado Springs, Fort Worth, Oklahoma City, Sherman-Denison, Tulsa, and Waco.**

Housing Activity and Consumer Spending Are Propping up the Economy...So Far. The telecommunications boom of the 1990s helped drive employment and population growth and housing construction activity throughout the Region, as well as office, industrial, and retail development. In fact, despite the current economic weakness, the Dallas Region continued to outpace the nation in job creation for the 12 months ending July 2001, thanks to continued strong housing activity and stable consumer spending. Retail sales for the Region's states were generally strong through the early part of this year; however, some weakness is beginning to emerge. Following the September 11 attacks, consumer spending can be expected to slow further, casting doubt on whether consumers can continue to be a source of strength for the economy.

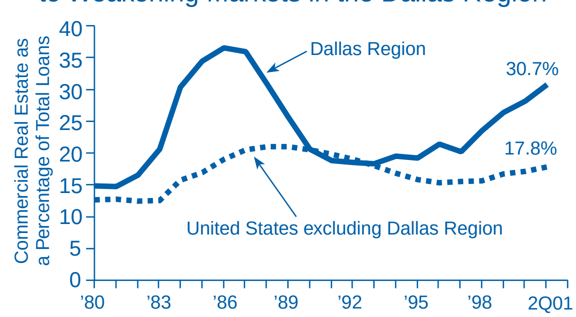
Through the first half of 2001, Colorado and **New Mexico** were on a pace to set record highs in existing home sales, according to data from the ***National Association of Realtors,*** while Oklahoma and Texas were each likely to achieve their second best year. A major contributing factor to the Region's strong housing market was lower interest rates. Thirty-year conventional mortgage interest rates fell more than 100 basis points below year-ago levels, averaging 6.95 percent as of August 2001, according to the ***Federal Reserve Board.*** In spite of the low interest rates, recent events, including the slowing economy and the fallout from the September 11 attacks, could dampen housing activity throughout the Region for the remainder of the year.

Insured Institutions in the Dallas Region Continue to Increase Exposure to Commercial Real Estate. Commercial real estate (CRE) lending by banks and thrifts has increased significantly over the past 3 1/2 years (see Chart 1). CRE loans currently represent 30.7 percent of total loans, the highest level since 1988 and much higher than the average for insured institutions in the rest of the nation. Higher CRE concentrations are most pronounced among insured institutions with assets between $500 million and $1 billion. This group showed the greatest increase among all size categories, with CRE loan volume rising to over 40 percent of total loans as of June 30, 2001. The Region's strong economic growth, accompanied by robust employment growth and in-migration, increased demand for real estate construction loans during this period. The favorable economic environment also helped mitigate credit quality issues that might have emerged during a weaker economy.

Past-due and charge-off rates among the CRE portfolios of the Region's insured institutions have increased slightly over the past several quarters but remain relatively low. However, CRE vacancy rates are beginning to rise, rapidly in some metropolitan markets with concentrations in high-tech employment. Although few expect a downturn in the Region's real estate market as serious as that of the 1980s, that experience highlights the potential risks of significant increases in CRE concentrations.

Chart 1

Expanded Commercial Real Estate Credit Exposure Increases Vulnerability to Weakening Markets in the Dallas Region



Note: Commercial real estate includes commercial, multifamily, and construction real estate
Source: Bank and Thrift Call Reports

Vacancy Rate Increases Are a Signal for Caution. Several markets in the Dallas Region, including **Houston,** Dallas, and Oklahoma City, have reported office vacancy rates higher than the national average during much of the 1990s. These higher vacancy rates can be attributed in part to the overhang in supply from the late 1980s and early 1990s. For the most part, this excess supply has been factored into considerations of price and insured institution financial exposure and is less cause for concern than the sharp increases in vacancy rates recently seen in numerous high-tech markets.

Many of these high-tech markets have enjoyed significant economic growth during the past decade, prompting financial commitments in the CRE sector. However, an outgrowth of the recent decline in the high-tech industry, in addition to an overall slowing in employment and in-migration, is excess office space in some of the larger metropolitan markets, such as **Austin** and Denver-Boulder. Additional supply is also under construction in these markets, and an increase in sublease space is being reported in these and several other markets. The result is rising vacancy rates and declining rental rates. Similar signs of weakness are spreading to other segments of the real estate market, including industrial, retail, multifamily, and residential space.

The Austin and Houston Real Estate Markets Offer Interesting Contrasts. By a conservative estimate, Austin high-tech employment accounted for 10.3 percent of the MSA's total employment as of June 30, 2001.[3] According to ***Torto Wheaton Research,*** the office vacancy rate for Austin at the same time stood at 11.8 percent, an unprecedented 680 basis point increase in six months. In fact, some analysts have argued that the true vacancy rate is closer to 20 percent when all space available for sublease is included. In addition, at year-end 2000, office space under construction totaled almost 10 percent of existing space. However, during the first six months of 2001, construction of several high profile office buildings, including the $124 million Intel complex downtown and a large Trammel Crow speculative building in north Austin, was put on hold. Even with these pullbacks, 450,000 square feet of new space came onto the market. At the same time, net absorption in the Austin market was a negative 1.3 million square feet, the highest level since 1987. The fallout from Austin's weakening high-tech sector has spread beyond office and industrial space into residential real estate, as described in a recent article in the ***Dallas Morning News*** that stated, "While preowned home sales in the area were down only about 6 percent as of June 2001, the number of homes on the market more than doubled."[4]

In contrast, Houston's office vacancy rate, although higher than that of the nation, rose by only 60 basis points during the first part of 2001. This contrast can be attributed in part to the fact that Houston has benefited greatly from a resurgence in the energy sector, which has offset the weakness in its high-tech industry.

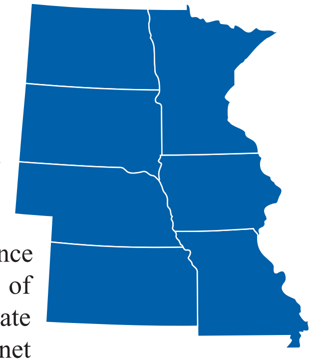
Where Do We Go from Here? The Dallas Region has increasingly moved away from a natural-resource-based economy (e.g., energy and agriculture) to a more diversified one characterized by high tech, transportation, and financial and business services. Thus, the Region is likely to feel the effects of any national downturn. Insured financial institutions in the Region's metropolitan markets with significant exposures to the high-tech sector may experience declines in loan quality in other categories of their portfolios than CRE, such as residential real estate. Following the September 11 attacks, other industries, such as airlines, defense, and energy, could experience continued volatility, which may affect local economies and banking markets. At this time, the challenge for the Region's insured institutions is to ensure that risk management strategies are in place to respond to a rapidly changing economic environment.

Dallas Regional Staff

[3] Source: Economy.com. Another estimate for the same period by AngelouEconomics places this figure at 19.7 percent.

[4] Brown, Steve. June 1, 2001. "High-tech hotbed's building boom hits wall during slowdown." *Dallas Morning News.*

Kansas City Regional Perspectives



Agricultural sector performance in the Kansas City Region continues to lag behind that of the nation. However, even though the Region's farm banks report sound financial conditions, borrowers' dependence on government support payments is extremely high, making asset quality difficult to assess. Federal government policy could change substantially when the 1996 Federal Agriculture Improvement and Reform (FAIR) Act expires next year. Vulnerability to changes in the type or level of government support varies greatly among the Region's farm banks at the county level.

The Region Will Not Share Fully in 2001 National Farm Income Increases

Despite the fact that national farm income is projected to increase in 2001, growth in the Region may lag behind that of the nation. The U.S. Department of Agriculture (USDA) has forecast an 8.6 percent increase nationally in net farm income in 2001, from \$46.4 billion in 2000 to \$50.4 billion, because of stronger farming revenue. However, \$6.5 billion, or more than one-half of the 2001 increase in farming revenue, is in dairy and poultry, which are not dominant in the Kansas City Region. Looking at the products that are important to this Region's farmers—notably wheat, corn, soybeans, cattle, and hogs—we see that revenue growth lags behind that of the nation's farm sector as a whole. In addition, the USDA estimates a 10 percent increase in the costs of manufactured inputs—pesticides, fertilizers and lime, petroleum fuels and oils, and electricity—that are used more intensively in the Kansas City Region. As a result, the Region's growth in farm income is not expected to be commensurate with that of the nation as a whole.

Moreover, the potential for the U.S. and world economies to slow further may have been heightened following the terrorist attacks of September 11, 2001. Should the global economy enter a recession, export demand for higher-valued commodities, such as processed meats, would be expected to decline, and commodity prices in the Region would likely remain low. Additionally, any future response to the attacks could cause some disruption in international agricultural trade.

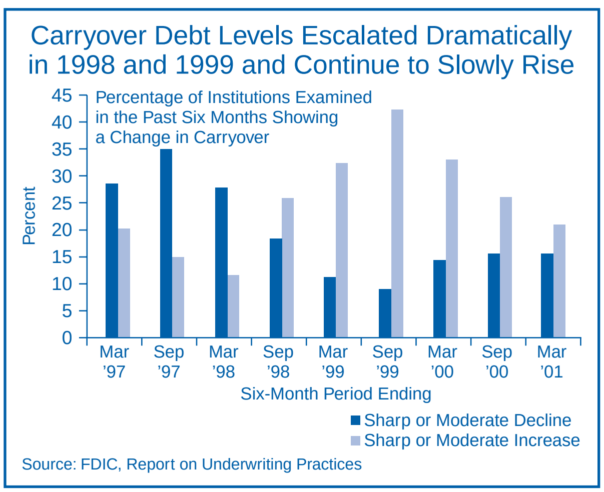
Farm Bank Asset Quality Could Be Fragile

Reported asset quality indicators continue to suggest strong credit quality overall, which contrasts somewhat with anecdotal evidence that shows increasing strain. As of June 30, 2001, farm bank aggregate noncurrent loans and leases and net loan and lease charge-offs represented a relatively low 1.14 percent and 0.16 percent of total loans and leases, respectively. Although up slightly from year-ago levels, these ratios are consistent with figures reported over the past several years and are low compared with historical standards. For example, in 1996, in what is considered the best year for the industry during the 1990s, these ratios were 1.22 percent and 0.15 percent, respectively.

Capital protection levels also remain high, as farm banks report an aggregate equity capital ratio and loan loss reserve to total loans ratio at 10.7 percent and 1.5 percent, respectively, as of June 2001. This is in line with recent historical trends. By contrast, these ratios were much lower at the beginning of the 1980s agricultural crisis, at 8.7 percent and 1.0 percent, respectively.[1]

However, anecdotal reports about rising carryover debt levels suggest that asset quality is becoming somewhat strained. Chart 1 shows the results of examiner surveys

CHART 1



[1] See Table 3 in "Agricultural Sector Under Stress: The 1980s and Today," *Kansas City Regional Outlook,* third quarter 1999.

about carryover debt levels. The rapid escalation in 1998 and 1999 reflects the effects of the plunge in commodity prices in 1997 and 1998. Despite four years of record direct government payments, the number of examiners indicating increased carryover debt has outnumbered those noting declines, indicating that farm loan portfolios may be weaker than the current loss and delinquency measures suggest.

Events of This Year Could Significantly Affect the 2002 Farm Bill Debate

The USDA estimates 2001 total direct government assistance of $20.4 billion. While this is almost 10 percent below the record high of $22.9 billion paid in 2000, it remains the third-highest amount ever paid and the third consecutive year that government payments have exceeded $20 billion.

The 1996 FAIR Act expires in 2002, and the debate can be expected to intensify about the fiscal role of the federal government in the agricultural sector. The direction that the next farm bill may take is highly uncertain, and any assessment at this point is preliminary. Only the House Agriculture Committee has drafted legislation; the Senate and the White House have yet to put forth their versions of a new farm bill. However, a changing economic outlook, which has become especially uncertain following the terrorist attacks on September 11, 2001, could affect the environment in which the farm bill is debated.

The House Agriculture Committee released its proposal in August, at which time large budget surpluses were forecast. Key provisions call for adding an additional countercyclical income payment to the current market transition and loan deficiency payments. Farmers participating in conservation programs would also benefit from additional funding, and more monies would be available for growers of commodities other than the traditional food grains, feed crops, and oil crops. The price tag over ten years would be $171 billion. When annualized, this is not much lower than the record-setting payments of the past four years and nearly double the amount of spending budgeted in the 2001 fiscal year budget.

However, these large budget surpluses appear to be dissolving quickly as both the Congressional Budget Office and the White House revised their fiscal year 2002 budget surplus forecasts downward by more than 40 percent. In addition, the terrorist attacks of September 11, 2001 enhance the uncertainty surrounding decisions related to future congressional and administration budget priorities. International trade negotiations could also affect the outcome of the farm bill debate. For example, the next meeting of the World Trade Organization is expected to include substantive debate about limiting farm subsidies.

Should the level of government payments decline and commodity prices not rebound, the quality of bank loans extended to borrowers concentrated primarily in food grains, feed crops, and oilseed production could deteriorate. As discussed in previous Kansas City Regional Perspectives articles, these commodities receive the large majority of direct government payments.[2]

Credit Risk Is Higher among Farm Banks in Counties Most Dependent on Government Payments

The Region's counties would be dissimilarly affected by a cut in government payments. Map 1 shows each county's dependence on direct government payments as a share of the county's total farming receipts in 1999 (government-payment dependence ratio).[3] The darker-shaded counties are those most dependent on government payments—at least 20 percent of their income is from such payments—and are referred to as "highly reliant" counties.

Recall that the period 1990 through 1996 is the most recent period of generally stable farming conditions prior to the commodity price slump that began in 1997. During that period, only 1 percent of all counties in the Region would have been considered highly reliant, and one-half of all counties had a government-payment dependence ratio of 6.8 percent or more. By 1999, after three years of depressed commodity prices, one-quarter

[2] "The Agricultural Sector Remains Depressed, with Low Commodity Prices," *Regional Outlook National Edition,* second quarter 2001, at http://www.fdic.gov/bank/analytical/regional/ro20012q/na/t2q2001.pdf, and "Farmers and Lenders Continue to Rely on Government Payments to Support Cash Flows and Farmland Values," *Kansas City Regional Outlook,* third quarter 2001, at http://www.fdic.gov/bank/analytical/regional/ro20013q/kc/k3q2001.pdf.

[3] 1999 is the most recent year that data on a county level were available. The data source is the Bureau of Economic Analysis, United States Department of Commerce. Total farm receipts is the combination of farm cash receipts and direct government payments.

Map 1

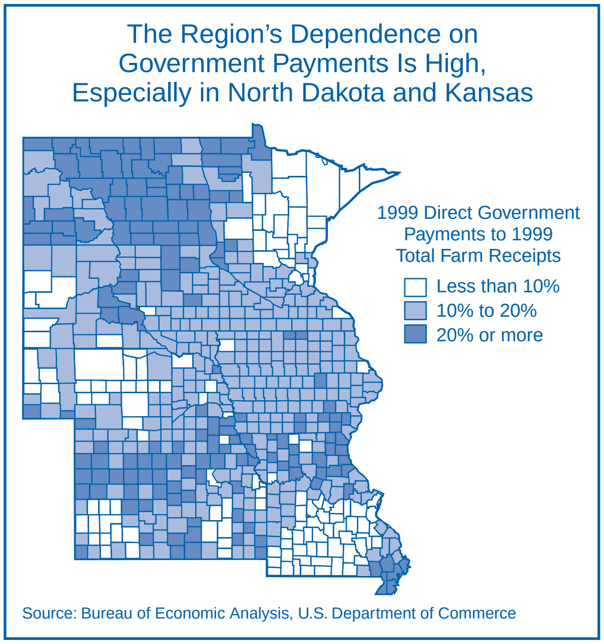
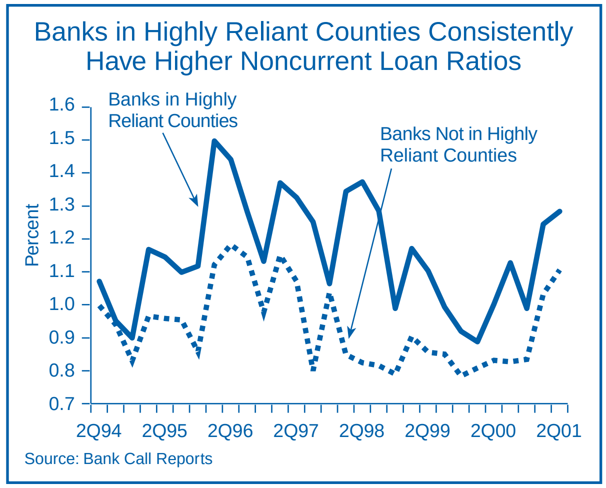


Chart 2



of the Region's counties were considered highly reliant, and the ratio for the top half of all counties more than doubled to 15.9 percent. Just as striking is that nearly every county in the Region is at least lightly shaded, indicating that 1999 government payments represented at least $1 out of every $10 in total farm receipts. North Dakota and Kansas are home to a disproportionate number of highly reliant counties with a concentrated production of heavily subsidized commodities, such as wheat, relative to the rest of the Region.

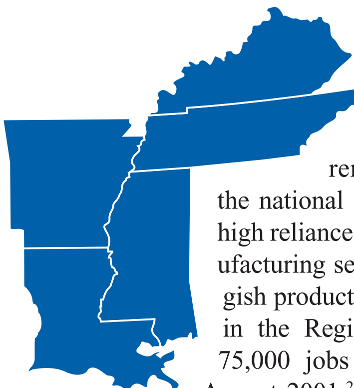
In general, farm banks in highly reliant counties have exhibited higher levels of credit risk than banks in other counties both before and during the recent agricultural slump. Chart 2 shows noncurrent loans as a percentage of total loans for farm banks headquartered in highly reliant counties and banks headquartered in all other counties. The trends show that government payments have similarly benefited the asset quality of both groups. Perhaps more important, banks in highly reliant counties consistently have reported a significantly higher noncurrent loan ratio, even during relatively good times, indicating heightened credit risk overall. Banks in counties showing the greatest reliance on government support payments already report higher levels of nonperforming loans. However, these institutions could experience greater loan quality deterioration should significant changes occur in government support programs.

Richard D. Cofer, Jr.
Senior Financial Analyst

Memphis Regional Perspectives

Economic Conditions in the Region Continue to Weaken

Economic growth throughout much of the Memphis Region slowed to a standstill in third quarter 2001. Employment growth for the 12 months ended August 2001 was flat, with more recent job formation turning negative.[1] The Region's economy is at its weakest since the 1990–1991 national recession and is currently underperforming the national economy because of its high reliance on the contracting manufacturing sector. To cope with sluggish product demand, manufacturers in the Region shed approximately 75,000 jobs from August 2000 to August 2001.[2] Job losses have spread to other sectors, most notably the construction sector but recently to the retail and transportation sectors as well. Employment growth in the service sector, which had previously compensated for job losses in other sectors, was virtually nonexistent in the three-month period ended August 2001.



The downturn in manufacturing and the spillover effects to other sectors have been most pronounced in **Mississippi, Arkansas,** and **Tennessee.** Mississippi has suffered considerably more than any other state in the nation, reporting more than 21,000 net job losses during the previous year,[3] more than double the number of job losses in the state during the 1990–1991 downturn. With both global and national economies weakening, conditions in the Region, which is already somewhat stressed by a prolonged localized downturn, could deteriorate further.

[1] From May 2001 to August 2001, the Region suffered a *net loss* of 9,000 jobs; that is, 9,000 more jobs were lost than created. State employment surveys (from which these regional data are derived) do not reflect the degree of slowing in employment growth shown by the more statistically valid national employment survey, suggesting that the Region's employment situation may be considerably worse than indicated.

[2] One important exception to negative trends in the Region's manufacturing sector during the previous year is automobile production. In Tennessee, Saturn and Nissan employ more than 14,000 people, and in Kentucky, Ford and Toyota employ approximately 16,000. National automotive sales in the first half of 2001 fared well, averaging 17 million units on an annualized basis, thanks in large part to low interest rates and considerable incentives. Declining consumer confidence and retail spending, however, could begin to affect automobile sales and production adversely if economic conditions remain weak.

[3] Although the contraction in the manufacturing sector has been a driving force in Mississippi's economic downturn, every major sector in the state except government reported negative job formation from August 2000 to August 2001.

Bank Credit Quality Has Deteriorated with the Downturn in Economic Conditions

Delinquencies and loan loss rates in the Memphis Region climbed from year-ago levels, and the current economic outlook suggests the potential for further deterioration. Median past-due and nonaccrual loans

Reduced Travel and Tourism Will Have a Greater Adverse Effect on Certain Markets in the Region

While the entire Region will continue to suffer the effects of a continuing economic slowdown, certain sectors and locations may be particularly hard hit by the sharp reduction in travel and tourism in the aftermath of September 11, 2001. The sectors include air transportation, recreation, and lodging.

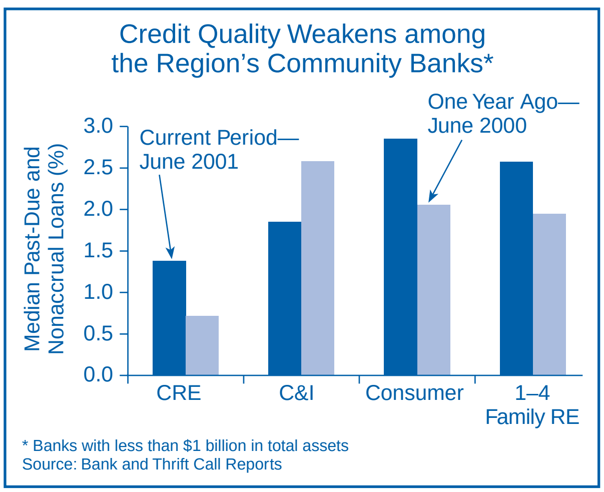
- ***Air Transportation:*** With the airline industry reducing flights and laying off approximately 20 percent of its workforce nationwide, areas with high exposure to the industry, such as Memphis and Louisville, will be hurt. The air transportation sector in both cities includes significant air cargo operations as well as commercial airline carriers, which mitigates the direct effects of reduced personal air travel to some extent. High exposure to air cargo operations, however, leaves the air transportation segment of these local economies heavily exposed to the overall national slowdown.

- ***Recreation and Lodging:*** Popular tourist locations, such as **Biloxi** and **New Orleans,** also are affected. In Biloxi, for example, air and water transportation, amusement/recreation, and hotel/lodging sector employment collectively represents 12.9 percent of total employment, the fifth highest concentration of any metropolitan market in the nation.

among the Region's community banks and thrifts (those with less than $1 billion in total assets) rose to 2.6 percent of total loans, up from 2.0 percent one year ago and now the highest among all FDIC Regions. The deterioration in credit quality has been widespread, with more than two-thirds of banks and thrifts in the Region reporting higher delinquencies than one year ago and almost half of all insured institutions reporting at least a 50 basis point increase in delinquencies. The current level of past-due and nonaccrual loans at most banks and thrifts remains at manageable levels, well below those reported during the prior national downturn. However, recent trends demonstrate some weakening in asset quality through the first half of 2001, consistent with slowing economic conditions. To date, consumer credit quality appears to have been affected most (see Chart 1), but given the potential for further broad deterioration in economic conditions, credit quality across all loan types may suffer in the near term.

Consumer Loans: Mounting job losses combined with high consumer debt levels have contributed to weaker financial conditions for many households. Personal bankruptcy filings in the Region in the first half of 2001 were up 27 percent from a year ago.[4] Although the number of filings may have been influenced by efforts to tighten bankruptcy legislation, the increase likely reflects the growing financial difficulties many borrowers face. Memphis Region banks and thrifts may be particularly susceptible to continuing deterioration in consumer loan portfolios, given the high proportion of low-income borrowers in the Region.[5]

CHART 1



Residential Loans: The quality of residential loan portfolios also could be affected adversely by the deterioration in household financial conditions. Credit risk in residential loans has been historically low and remains moderate compared with other loan types. Dramatic changes in residential lending during the 1990s, however, likely have increased the overall credit risk in residential portfolios. New loan products and programs facilitated financing for many first-time home buyers who might not previously have qualified for loans and allowed existing homeowners to increase their home-secured debt levels substantially. As a result, loss rates on residential loan portfolios at community banks could rise higher than previously experienced.

Commercial Real Estate Loans: Commercial real estate loans reported by commercial banks consist of three general types: loans secured by nonresidential properties, construction and development loans for both commercial and residential properties, and loans secured by multifamily properties. Delinquency ratios increased for all three types, but increased most for construction and development loans. Growing inventories of unsold new homes are driving the increases in construction loan past-due ratios. Delinquencies on nonresidential properties were also higher as an uncertain economic outlook led to sharply reduced demand for commercial real estate in the first half of 2001 and to rising commercial vacancy rates in both the Region and the nation.

Commercial and Industrial Loans: Unlike other major loan categories, the median ratio of past-due and nonaccrual commercial and industrial loans as of June 30, 2001, declined from year-ago levels. This apparent improvement in commercial credit quality was not widespread, however, as larger financial institutions reported higher commercial loan delinquencies. The 25 largest insured institutions in the Region—those with total assets in excess of $1 billion—reported an 80 basis point increase in median commercial loan delinquencies. Furthermore, 58 percent of banks with total assets

[4] The 27 percent surge in personal bankruptcy filings in the Region during the first half of 2001 is higher than the 21 percent increase reported nationally. Among the Region's states, Arkansas reported the sharpest increase in personal bankruptcy filings at 37 percent. Louisiana was the only one of the Region's states to report a smaller increase than the nation, consistent with that state's relatively stable economy.

[5] Studies suggesting that debt burdens have increased most among low-income borrowers during the recent expansion are described in more detail in "Changing Economic Conditions Affect Bank and Thrift Earnings and Asset Quality," *Regional Outlook,* third quarter 2001.

ranging from $250 million to $1 billion reported an increase in past-due and nonaccrual levels from one year ago. These trends in larger institutions, along with declining corporate profitability and a slowing national economy, suggest that commercial loan credit quality for institutions of all asset sizes could deteriorate. Historically, commercial lending has experienced the sharpest increase in nonperforming loan levels and loan losses during economic downturns.

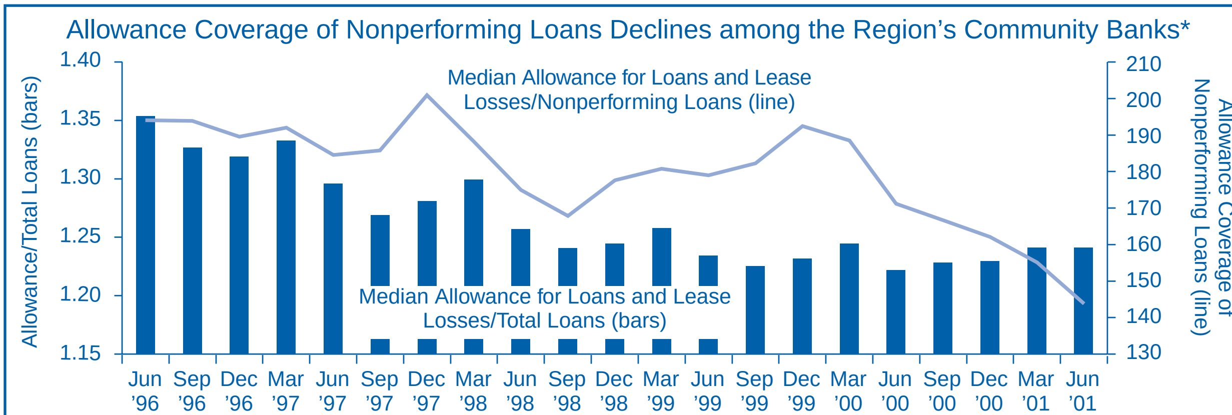
Agricultural Loans: Despite continued low commodity prices, agricultural credit quality has remained generally sound, primarily because of record government subsidies and previously strong growth in off-farm income. Going forward, however, both sources of support may decline and adversely affect agricultural loan credit quality. Government support levels could diminish when the 1996 Freedom to Farm Act expires in 2002. Budgetary pressures caused by a slowing national economy and a shift in national priorities after the September 11 attacks could result in less government support under the new farm bill. Off-farm income is likely to fall with swelling job losses; many agricultural borrowers are small operations that draw a significant share of total household income from off-farm sources.

Further Deterioration in Credit Quality Could Have a Pronounced Adverse Effect on Earnings Performance

Earnings performance was already under pressure.[6] Net interest margins (NIMs) at most banks and thrifts in the Region have declined steadily since the mid-1990s, largely as a result of intense competitive pressures that affected both loan pricing and funding costs. In the first half of 2001, NIMs were further pressured as a result of rapidly declining interest rates. Most insured financial institutions were unable to lower funding costs at a pace commensurate with the steep reductions in asset yields. This trend is likely to continue in the near term, given further interest rate declines in third quarter 2001. While bank and thrift earnings performance should benefit in the longer term from the recent steepening of the yield curve, any resulting improvements in NIMs[7] could be offset by increased provision expenses.

Throughout the 1990s, insured financial institutions made provisions to the allowance for loan and lease losses (ALLL) well in excess of loan loss experience. However, the additions did not keep pace with the growth in total loans, and ALLL levels declined relative

CHART 2



*Banks with less than $1 billion in total assets
Source: Bank and Thrift Call Reports

[6] The annualized median return on assets (ROA) for insured institutions in the Memphis Region for the first six months of 2001 was 0.98 percent, down sharply from the 1.19 percent ROA reported in the first half of 2000. The median NIM for second quarter 2001 was 4.02, the lowest level reported in the 17 years that the data have been collected. For comparison, the median NIM in second quarter 2000 was 4.39 percent.

[7] The positive effects of a steepening yield curve may be offset in part by declining loan volumes. As loan demand wanes with weaker economic conditions, the resulting shift from loans to lower-yielding assets could affect margins adversely.

to total loans. This decline presented little cause for concern, as overall loan quality improved throughout the mid-1990s and remained strong in the late 1990s. Although ALLL levels were declining relative to total loans, allowance coverage of nonperforming loans remained high. Since mid-2000, however, allowance coverage levels have fallen sharply (see Chart 2), as nonperforming loan levels have climbed. While the adequacy of allowance protection at banks and thrifts is influenced by many factors specific to the individual institution, aggregate trends suggest that some banks and thrifts may need to increase provisions to the ALLL if credit quality continues to deteriorate, further pressuring earnings performance.

The effects of any continued deterioration in credit quality on ALLL adequacy, earnings performance, and ultimately on capital may be magnified by currently high credit exposure levels. Loan-to-asset (LTA) ratios reported by the Region's insured financial institutions at mid-2001 were near historically high levels and were considerably higher than those reported in previous economic cycles.[8] The Region's insured financial institutions reported a median LTA ratio of 64.5 percent as of June 30, 2001, compared with a median LTA ratio of 55.4 percent prior to the 1990–1991 national downturn. Furthermore, the increase in loan levels has been driven primarily by growth in traditionally higher-risk loan types, such as commercial real estate and commercial loans. Because of this markedly elevated credit exposure entering the current downturn, any increases in loan loss rates and nonperforming asset levels likely will have a more pronounced effect on earnings and capital than was the case during previous periods of economic weakness.

Memphis Regional Staff

[8] The historical high for median LTA levels among insured financial institutions in the Memphis Region was reached on September 30, 2000, at 66.1 percent. From 1972 to the mid-1990s, the median LTA ratio typically ranged from 50 to 56 percent.

New York Regional Perspectives

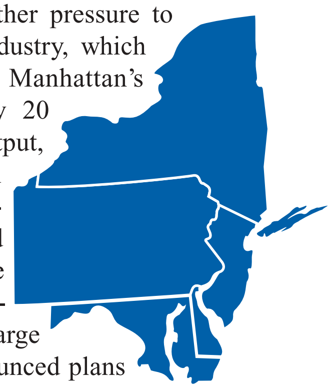
Economic Landscape Dramatically Altered

The tragic events of September 11, 2001, dramatically altered the economic landscape of the nation and the Region. Repercussions from the massive destruction and loss of life reverberated through the nation and the world. Before the attack, the Region's economy, although weakening, had enjoyed stronger growth than that of the nation. Although estimates of the severity and longevity vary, the widespread economic disruption that followed the attack could tip the nation's and Region's economies into recession.

New York City: Damage Estimates Climb

The attack on the World Trade Center left 22 office buildings in downtown New York destroyed or damaged.[1] These buildings represented 9 percent of **Manhattan's** total office market and encompassed 30.3 million square feet,[2] roughly equivalent to the total amount of office market space in the central business districts of **Kansas City, Milwaukee,** and **Nashville** combined. Early estimates of the structural damage exceed $20 billion, while total economic losses have been estimated as high as $105 billion over two years for **New York City** alone.[3] Federal funding of $20 billion and insurance payments estimated to reach as high as $70 billion will offset a portion of lower Manhattan's cleanup and rebuilding costs.[4]

According to the ***New York State Department of Labor,*** job losses emanating from the attack exceed 100,000, or approximately 3 percent of the city's workforce.[5] Airlines and tourism-related businesses have been the hardest hit, reflecting the immediate cessation of tourism and business travel to the area. Securities firms, which had endured declining earnings before September 11, now face further pressure to curb costs. The securities industry, which accounts for 5 percent of Manhattan's workforce but approximately 20 percent of its economic output, cut 15,000 jobs in the nation over the past year, with another 12,000 layoffs announced but not enacted before the attacks. In the weeks following September 11, several large financial services firms announced plans to reduce staff significantly. In addition, compensation in the securities industry likely will decline. Year-end bonuses, which typically make up a significant portion of salaries, are expected to decline by 40 to 60 percent in 2001, severely dampening consumer spending in New York City and the surrounding areas.[6] Because the securities industry is an important economic driver, a significant decline in compensation could hinder the Region's economy. Softness also can be expected in many industries that support the securities industry, including advertising, printing, and publishing.



A few of the area's industry sectors may benefit during the post-attack period. Neighboring commercial real estate markets, including those in **Brooklyn, Westchester,** midtown Manhattan, and **northern New Jersey,** are poised to benefit as displaced firms relocate. This demand comes precisely as office market conditions had been weakening. Furthermore, construction, security, and industrial sanitation workers may be needed to assist in the cleanup.

Economic Damage Spills Over to Other Parts of the Region

Many of the Region's other areas have been affected by the attack. According to ***Economy.com***, estimated gross product or economic output for many of the Region's largest metropolitan statistical areas declined significantly following the attack (see Table 1). **Newark**, **Pittsburgh**, and **Washington, D.C.**, in particular, are vulnerable to declines in air traffic because of high

[1] Grubb & Ellis estimated that approximately 13 million square feet of damaged office space could return to the market within three to 12 months. Grubb & Ellis Research. September 2001.

[2] October 2001. "Evaluating the Impact of the World Trade Center Disaster on the New York Office Leasing Market." *Reis Reports.*

[3] October 4, 2001. "The Impact of the September 11 WTC Attack on NYC's Economy and City Revenues." *New York City Comptroller's Office.*

[4] September 15, 2001. "The Biggest Bill of All." *The Economist.*

[5] Pristin, Terry, and Leslie Eaton. September 26, 2001. "Disaster's Aftershocks: Number of Workers Out of a Job Is Rising." *New York Times.*

[6] McGeehan, Patrick. September 26, 2001. "Struggling Wall Street Is Loath to Cut Jobs." *New York Times.*

concentrations of airline jobs. While the $15 billion financial aid package to the airline industry should help financially troubled airlines, cities that serve as hubs may be affected more seriously. Pittsburgh is a major hub for U.S. Airways, which is considered one of the more financially vulnerable airlines.[7] **Philadelphia** and **Baltimore** face job losses as U.S. Airways contracts operations in those cities. Continental Airlines, which also announced job cuts, has a significant presence at Newark International Airport. The temporary closure of Reagan Washington National Airport near the nation's capital could result in substantial loss of jobs and revenues in neighboring areas. Other transportation providers, including shipping and trucking companies, also have been seriously affected. These industries, which are significant in **Jersey City** and **Gloucester County, New Jersey,** and **Harrisburg, Pennsylvania,** face decreasing demand as the nation's economy slows and increasing costs as security measures are implemented.

A decline in revenue from tourism also has hurt many of the Region's other cities. Estimated losses from convention cancellations in Baltimore exceed $20 million, and hotels in the city's Inner Harbor, a popular tourist area, have released a quarter of their staff. **Puerto Rico's** tourism industry could suffer from reduced air traffic. Tourism accounts for 14,000 jobs, less than 2 percent of the island's workforce, but this sector contributed over $2 billion to the economy in 2000.[8] Although **Atlantic City** has one of the nation's highest employment concentrations in tourism-related businesses, it may be less affected than other destinations because only 2 percent of its visitors arrive by air.[9]

Increased Uncertainty Clouds Economic Outlook

Preliminary forecasts suggest that the duration of this economic downturn may be shorter for the Region and New York State than the 1990–1991 recession. According to ***Economy.com,*** during the 1990 recession, New York State's economy contracted for five consecutive quarters from third quarter 1990 through third quarter 1991, contracting by almost 8 percent in first quarter 1991. After September 11, baseline forecasts call for New York's gross state product, the broadest measure of the economy, to decline significantly during the second half of 2001 but then begin to expand, albeit very modestly, in first quarter 2002.[10]

TABLE 1

REGION'S PROJECTED ECONOMIC GROWTH DECLINED SIGNIFICANTLY FOLLOWING SEPTEMBER 11TH

Metropolitan Area	Estimated Gross Product (billions–1996 dollars)	% Projected Growth Rate 2001: Before Sept. 1	% Projected Growth Rate 2001: After Sept. 11	Point Change
New York City	493.1	1.14	–4.14	–5.28
Washington, D.C.	224.1	2.08	0.88	–1.20
Philadelphia	181.0	0.68	–0.38	–1.06
Nassau–Suffolk	95.1	1.29	0.36	–0.93
Newark	93.3	0.91	–0.23	–1.14
Baltimore	87.5	0.46	–0.49	–0.95
Pittsburgh	74.7	–0.08	–1.11	–1.03
Middlesex–Somerset–Hunterdon, NJ	62.5	0.74	–0.28	–1.02
Bergen–Passaic, NJ	56.1	0.20	–0.90	–1.10

Note: Economic growth measured as growth between fourth quarter 2000 and fourth quarter 2001.
Source: Economy.com October 2001 forecasts

[7] James, Raymond. September 25, 2001. "Equity Research."

[8] September 20, 2001. "A Big Blow to Tourism." *Caribbean Business.*

[9] Swavy, Joseph. September 22, 2001. "Area Has Few Flying Tourists to Lose." *Press Plus Online: The Press of Atlantic City.*

[10] Economy.com. October 22, 2001, forecasts.

New York City's economic downturn is forecast to be more significant and to last longer than the state's. The city's economic growth is not expected to return to pre-attack levels until mid-2003.[11] The infusion of financial aid (the economic effects of which typically are felt within six to nine months), and favorable changes in federal monetary and fiscal policies should help cushion the city's economy during the cleanup period. Additionally, stronger office market fundamentals than a decade ago should buffer the effects of the attack on the city's economy over the short term. While home prices in the New York City metropolitan area have declined, reflecting the weakened economy, price declines are estimated to be less than in some other parts of the country.[12] Nevertheless, lower home prices translate into less household wealth, which could constrain consumer spending severely. The city's long-term outlook will depend, in part, on the extent to which companies and people permanently relocate out of Manhattan. Additional terrorist acts in the United States and future military actions abroad could erode consumer confidence further and undermine the economy.

Banks Face Increased Credit Quality and Earnings Pressures

Increased economic slowing following the attack will place additional pressure on credit quality and bank earnings. Unlike the 1990–1991 recession, when loan portfolios were hurt primarily by problem commercial real estate loans, credit problems in this downturn likely will be concentrated in commercial and industrial (C&I) loans. Before September 11, the Region's large banks (those with assets greater than $10 billion) had reported credit quality deterioration, which generally reflected weakness in large syndicated loans. At June 30, 2001, large banks reported a C&I delinquency rate of 2.29 percent, a seven-year high but significantly below the peak delinquency rate of 7.0 percent reached at the height of the 1990–1991 recession.[13] Net charge-off rates on C&I loans reported by the Region's large banks also have increased but remain well below heights reached a decade ago. Before the attacks, large bank credit quality weakness was primarily concentrated in a few industries, such as telecommunications, entertainment, and health care; however, weakness could spread to other industries as the nation's economy weakens more broadly. The ability of some large banks to sell problem loans to investors may partially mitigate the effect of credit quality weakness on delinquency and charge-off ratios. In addition to potentially higher credit costs, large bank earnings will be constrained by lower capital market revenues and additional venture capital losses, reflecting both losses during the days the financial markets were closed and further slowdown in capital market activities.

The Region's smaller institutions, particularly those in New York City, also face a more challenging banking environment after September 11. Institutions that have a concentration in loans to businesses that operate in the city could experience strained credit quality, reflecting business closures and a generally weaker economy.[14]

Institutions that specialize in residential real estate lending in New York City and surrounding suburbs also could face increased credit quality weakness should residential home values soften significantly. However, the average past-due loan ratio for residential real estate lenders in the New York City area remained low through the first half of 2001, below that of residential real estate lenders in the Region and the nation.[15] Furthermore, lower interest rates have resulted in increased refinancing activity, which should help consumers' debt repayment capacity and mortgage loan quality. Although lower short-term interest rates should alleviate pressure on net interest margins, the benefits may be somewhat diminished because loan yields may decline more than deposit rates, which may be near floor levels for some institutions. As a result, banks with a greater reliance on wholesale funds may benefit from declining short-term rates more than those that rely on retail deposits.

[11] Ibid.

[12] According to the *Wall Street Journal,* the median home price in the New York area is expected to decline by 0.7 percent over the next year, far less than the 3.1 percent decline forecast for San Francisco. September 21, 2001. "Where's Housing Headed?"

[13] The banking analysis excludes banks in operation less than three years, credit card institutions, and specialty banks. Median figures are used unless otherwise noted.

[14] Banks with at least 25 percent of total assets in C&I and commercial real estate loans are defined as commercial lenders. There are 48 commercial lenders with total assets less than $10 billion in the New York City metropolitan statistical area (MSA), comprising 56 percent of total established institutions in the MSA.

[15] Residential real estate lenders are defined as those that have at least 50 percent of assets in residential real estate loans and mortgage-backed securities. The New York City area includes the New York City MSA and the seven surrounding MSAs.

Economic Uncertainty Is High, but Institutions Appear Better Positioned than a Decade Ago

The high degree of economic uncertainty could pressure bank earnings and credit quality. Nevertheless, the Region's institutions, in aggregate, appear better positioned for an economic downturn than in the early 1990s. As of June 2001, the percentage of the Region's institutions with concentrations in traditionally higher risk loan categories expressed as a percentage of equity capital was less than before the 1990–1991 recession (see Chart 1).[16] Institutions in the Region's major metropolitan areas increased risk profiles more modestly during the 1990s' business expansion than during the similar 1980s' period. Loan growth rates and concentration levels of traditionally higher-risk loans for many of the Region's banks are less than in some other parts of the country, such as the Southeast and West. Furthermore, while approximately half the Region's institutions reported increased loan delinquency and charge-off rates over the past year, average past-due loan and charge-off ratios remained well below those of the period before the last recession. Slightly higher aggregate capital ratios also should help cushion banks from lower earnings and credit quality deterioration.

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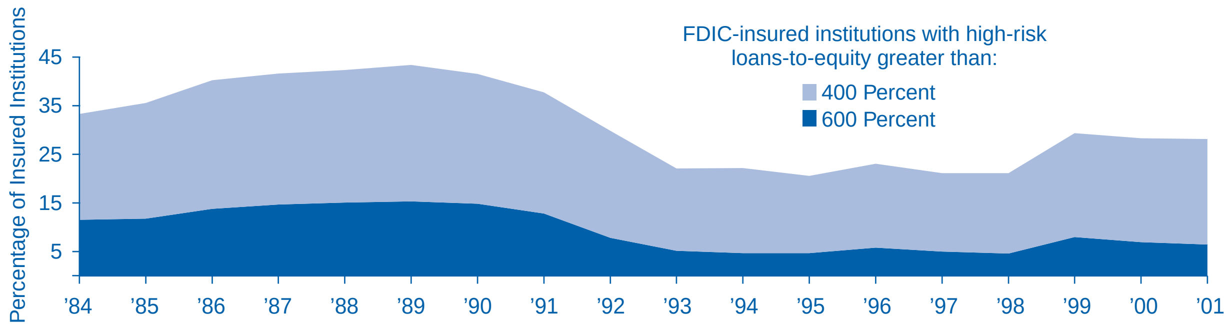
CHART 1

High-Risk Loan Concentrations Increase but Remain Lower than in the 1980s



Note: High-risk loans are defined as commercial and industrial, commercial real estate, and construction and development loans. 2001 data as of second quarter. Excludes credit card banks, specialty banks, and institutions in operation less than three years.
Source: Bank and Thrift Call Reports (FDIC Research Information System)

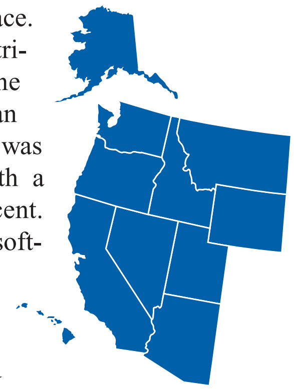
[16] Higher-risk loans are defined as commercial real estate, construction and development, and C&I loans. Institutions exclude credit card banks, specialty banks, and institutions in operation less than three years.

San Francisco Regional Perspectives

The Region's Slowing High-Tech Sector Has Dampened Employment Growth and Demand for Commercial Real Estate

Softening in the San Francisco Region's high-tech sector contributed to slower employment growth during the first half of 2001 and to rising vacancy rates in several commercial real estate (CRE) markets. In the second quarter of 2001, the Region's nonfarm seasonally adjusted employment growth rate was 2 percent, higher than the national rate but much slower than recent periods. Job growth deceleration was especially prominent in **Oregon, Washington, Arizona,** and the **San Francisco Bay Area,** where high-tech industries are important.[1] Furthermore, during the first six months of 2001, companies based in **Silicon Valley,** the **Pacific Northwest,** Arizona, and **Southern California** experienced steep declines in venture capital financing, a key source of funding for the high-tech boom.[2]

Layoffs and declining venture capital in several formerly "hot" high-tech markets—such as the San Francisco, **San Jose, Oakland, Seattle,** and **Phoenix-Mesa** metropolitan statistical areas (MSAs)—also contributed to negative net absorption and rising office availability rates[3] in the first half of 2001.[4] Compounding the problem, 9.6 million square feet of office space were added in these five markets, pushing the aggregate office vacancy rate from 5.4 percent to 10.9 percent over the first six months of 2001. In addition, the amount of available industrial space increased in the first half of 2001 in several of the Region's MSAs, and some planned projects have slowed or halted. Softening in certain industrial markets is largely attributed to curtailed storage requirements and the resulting declining demand for warehouse space. In the aggregate, the industrial availability rate in the Region's major metropolitan areas as of midyear 2001 was 7.4 percent, compared with a national rate of 8.2 percent. Given ongoing economic softening aggravated by the terrorist attacks in September 2001, the office, industrial, hotel, and retail property markets may experience further weakening.



Continued CRE market softening could pressure asset quality, particularly among insured institutions lending in high-tech and tourism-dependent markets, where CRE loan concentrations tend to be high. For instance, institutions headquartered in the San Francisco, San Jose, Oakland, Seattle, and Phoenix-Mesa MSAs reported a median CRE loan-to-Tier 1 capital ratio of 375 percent as of second quarter 2001, compared with 194 percent for insured institutions headquartered in all other MSAs in the nation. Although CRE loan concentrations in these areas have historically exceeded national benchmarks, they have increased substantially since 1990, when the median CRE loan-to-Tier 1 capital ratio in these five markets was 256 percent. Commercial construction loans in these markets could be particularly vulnerable to default risk if completed projects encounter unexpectedly high vacancy rates, low rental rates, and high capitalization rates.

Home Price, Underwriting, and Household Leverage Trends Could Increase the Vulnerability of Some of the Region's Residential Lenders, Given Recent Refinancing Activity

Although home sale volumes were robust in many markets during the first half of 2001, residential lenders could face increasing credit risk because deteriorating affordability and softening economic conditions could adversely affect home values in some areas. Mortgage credit quality could also come under pressure, given relatively narrower mortgage collateral margins and rising household debt levels. In addition, a significant volume

[1] As used here, the high-tech sector includes the following industry groupings: biotechnology, computers and electronics, telecommunications, and computer and data processing. The sector is important to several MSAs where high-tech employment has grown more rapidly than the national average. In addition, several MSAs report a higher concentration of high-tech employment than the national average. For additional information see "San Francisco Regional Perspectives," *Regional Outlook*, third quarter 2000.

[2] Sources: http://www.ventureone.com and http://www.pwmoneytree.com.

[3] The availability rate indicates the percentage of commercial real estate space that is physically vacant or available for lease by the current occupant.

[4] Murray, Tom. Third quarter 2001. "Slowing Economy Reduces Demand for U.S. Office Space." *Regional Outlook*.

of home loans was originated in 2001 in response to falling interest rates, and such loans may be predicated on unsustainable home values.

Several California Markets Could Be Vulnerable to Housing Price Bubbles

Between 1995 and 2000, housing prices increased significantly in several of the Region's MSAs; however, household income levels did not keep pace in some markets, leading to deteriorating affordability. According to the Office of Federal Housing Enterprise Oversight, a "prolonged and rapid" increase in the ratio of home prices to household income might be a sign of "an overshooting cycle, or a bubble."[5] On the basis of median home price and household income levels and trends, 9 of the Region's 55 MSAs could be vulnerable to housing price bubbles (see Table 1). These metropolitan areas have low Housing Affordability Indices (HAI), and their HAIs have deteriorated by 15 percent or more over the past five years.[6] Not surprisingly, all of the Region's markets with low and significantly deteriorating housing affordability are in or near areas with concentrations in high-tech employment (i.e., high-tech jobs account for at least 5 percent of all nonfarm employment). In fact, seven of these nine markets are adjacent to California's Silicon Valley. Recent volatility in high-tech stock prices, sagging venture capital funding, and the recent significant number of layoff announcements could also pressure home prices in these markets.

The potential for home price softening, however, is not limited to the San Francisco Bay Area, **Orange County,** and **San Diego** metropolitan areas. Given generally weakening economic conditions and rising household leverage, MSAs throughout the Region might face slowed or negative home price appreciation in the near future. Additionally, effects of the September 11, 2001, terrorist attacks could challenge consumer confidence and possibly dampen home sales activity nationwide. Realtor surveys and market data suggest that in some areas home prices are already falling and that the average number of days on the market is lengthening.[7] Based on historical experience of downturns, high-end homes could face the largest adjustments in value, because the available pool of qualified buyers tends to be smaller.

Table 1

Housing Affordability Was Low and Deteriorated Rapidly in Nine California MSAs

MSA	December 2000 HAI	HAI Change (1995–2000)
Salinas	40	–46%
San Francisco	57	–25%
Santa Rosa	59	–19%
Oakland	61	–15%
Santa Cruz–Watsonville	63	–19%
San Diego	68	–22%
San Jose	73	–19%
Vallejo–Fairfield–Napa	74	–30%
Orange County	75	–19%
United States	115	–4%

Source: Economy.com
HAI = Housing Affordability Index; MSA = Metropolitan Statistical Area

[5] March 1, 2001. Office of Federal Housing Enterprise Oversight. *House Price Index, Fourth Quarter 2000*. 7–8.

[6] As calculated by Economy.com. The HAI measures the extent to which a median family income can afford a median-priced home within a market, given certain assumptions, such as a 20 percent down payment. A declining HAI indicates that growth in median home prices has outpaced median household incomes.

[7] California Association of Realtors. July 2001. *Trends in California Real Estate*.

Underwriting Standards Have Loosened and Consumer Leverage Has Increased

Many residential lenders have eased underwriting standards over the past decade. For instance, between 1990 and 2001, the proportion of home purchase loans with loan-to-value ratios exceeding 90 percent increased from one-tenth to nearly one-quarter.[8] Although lenders often obtain private mortgage insurance (PMI) to offset collateral risks, the risk profile of several major PMI issuers may be rising, given their increased involvement in subprime mortgage loans and pools. PMI companies have reported that the premiums associated with these new lending risks will offset any losses; however, the ability of PMI issuers to sustain subprime defaults through a complete business cycle is largely untested.

Rising household debt levels could also pressure mortgage credit quality. Federal Reserve data suggest that household leverage is increasing and debt serviceability is deteriorating (see *San Francisco Regional Perspectives*, first quarter 2001). Falling interest rates could ease debt service ratios in the near term. However, many households have used the latest drop in interest rates to further leverage their homes via "cash out" mortgages.[9] Also, mortgage delinquency and personal bankruptcy rates rose in many of the Region's states in the first half of 2001, despite declining interest rates.

Affordability, Underwriting, and Household Leverage Trends Could Pressure Mortgage Lenders

In the event of continued economic softening, the combination of rapidly deteriorating housing affordability, elevated loan-to-value ratios, and high consumer leverage could expose some lenders to increasing residential mortgage defaults. The timing of the recent refinancing boom could add to the challenges facing insured institutions. According to some estimates, nearly one out of every three mortgage dollars will have been underwritten in 2001.[10] Given that appraisers rely on historical data to estimate home values and that some lenders have begun using automated home valuation services, recent loans could be predicated on unsustainable home values in some areas. In particular, community mortgage lenders[11] headquartered in the nine California markets listed in Table 1 could be vulnerable if mortgage portfolios are concentrated in these locations. Lenders specializing in speculative residential construction, subprime mortgages, or high loan-to-value second liens could also sustain elevated losses if home values decline.

The Agricultural Economy in Some of the Region's Rural Areas Is Under Stress

Agricultural loan portfolios at some of the Region's insured institutions are facing increasing stress, given persistent drought conditions in states such as Washington, Oregon, **Montana,** and **Idaho** and projected declines in government subsidy payments. Nearly 15 percent of the Region's insured institutions, headquartered primarily in the rural areas of Montana, **Wyoming,** Washington, Oregon, and Idaho, report agricultural production and farm real estate loans exceeding Tier 1 capital levels. The confluence of continued low commodity prices, emerging drought conditions, and potential declines in government farm subsidy payments could especially affect insured institutions lending in Montana, Washington, and Oregon.

Drought Conditions Have Persisted

Several agriculture-dependent areas of the Region endured moderate to severe drought conditions in spring and summer 2001, following an already dry 2000 growing season. Summer precipitation levels in the Pacific Northwest were the lowest since 1977,[12] and drought conditions were expected to persist at least through year-end 2001.[13] Concerns are amplified by already low prices for commodities, such as wheat and

[8] Federal Housing Finance Board via Haver Analytics. Note: This statistic is based on average loan-to-price ratios for "purchase money" mortgages only (i.e., collateral ratios on loans used to buy homes). These data could understate the proportion of highly leveraged homes, because it does not include borrowers who have used a second-lien mortgage to finance a portion of the home purchase (e.g., an "80-10-10" loan), and it also excludes loan-to-value ratios on mortgages used to refinance existing debt.

[9] A "cash out" mortgage is a loan that provides additional cash to the borrower beyond amounts paid to refinance existing mortgage debt.

[10] The Mortgage Bankers Association projects 2001 residential loan originations approximating $1.5 trillion, or 32 percent of all estimated home mortgage debt.

[11] Community mortgage lenders include insured institutions with total assets of less than $1 billion and residential mortgage loan exposures exceeding Tier 1 capital.

[12] The Pacific Northwest includes Washington, Oregon, and Idaho. Data are 12-month moving averages.

[13] Source: U.S. Drought Monitor, Climate Prediction Center, National Oceanic and Atmospheric Administration (NOAA), as of August 17, 2001.

potatoes, and rising farm energy costs in several western states. Consequently, the condition and yield of some grain and potato crops in Montana and Idaho are reported to have deteriorated. Furthermore, a number of farmers in Oregon's Klamath River basin have been without irrigation water since early April 2001 because of a federal decision to stop irrigation in order to protect endangered fish. In addition, the lack of water in several areas of the Region has caused deterioration in pasture feed and hay, resulting in higher costs to ranchers who have to purchase additional feed for livestock.

Some States Rely Heavily on Government Subsidies

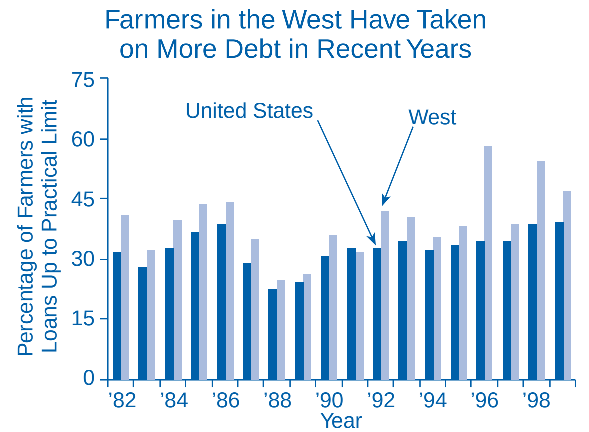
Recently, some states in the Region have relied heavily on government payments to supplement low commodity prices and compensate for emergency situations; consequently, these areas have become increasingly vulnerable to projected payment reductions during 2001.[14] Moreover, future farm bill payments face new uncertainties—recent budget pressures could reduce or limit the amount of federally funded farm relief. Farm subsidy reductions could affect agricultural producers in Montana and Washington in particular, where government payments accounted for 168 and 44 percent of these states' respective net farm incomes in 2000. Thus far, such payments have helped mitigate farmers' or agricultural lenders' losses. However, the quality of farm loan portfolios of several insured institutions in subsidy-dependent areas could deteriorate if the level of government payments declines substantially.

Financial Condition of the Region's Rural Banks Has Exhibited Some Softening

In aggregate, the Region's 117 agricultural lenders[15] reported sound financial conditions as of midyear 2001. However, for the one-year period ending June 30, 2001, many of these institutions reported lower return on average asset ratios, declining leverage capital ratios, and rising levels of loan delinquencies. Furthermore, the results of an American Bankers Association survey detailed in a U.S. Department of Agriculture publication indicates that a large share of farm borrowers in the West[16] are "loaned-up to the practical limit" (see Chart 1).[17] If farm borrowers in the West are further stressed by drought conditions or subsidy cuts, they might face repayment problems on loans to insured institutions.

San Francisco Regional Staff

CHART 1



Source: American Bankers Association—Farm Credit Situation Survey

[14] Nationally, government payments reached a new high of $22.9 billion in 2000, but the U.S. Department of Agriculture expects subsidies to fall to $20 billion in 2001.
[15] Defined as insured institutions with total assets of less than $1 billion that have agricultural lines and farm real estate loans exceeding Tier 1 leverage capital.

[16] The West includes Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, and Wyoming.
[17] Stam, Jerome B., Daniel L. Milkove, and George B. Wallace. February 2000. *Indicators of Financial Stress in Agriculture Reported by Agricultural Banks, 1982-1999.* Washington, D.C.: Economic Research Service/USDA.

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